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Nor Rhyme Nor Reason: Simplifying Defined Contribution Plans

David A. Pratt
Albany Law School

Nor Rhyme Nor Reason: Simplifying Defined Contribution Plans

DAVID A. PRATT†

I was promised on a time
To have reason for my rhyme;
From that time unto this season,
I received nor rhyme nor reason.[1]

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† Professor of Law, Albany Law School; of counsel to Hodgson Russ LLP, Albany, New York and to Downs, Rachlin & Martin PLLC, Burlington, Vermont. I wish to thank my children, Nick, Sarah, and Sam, for everything they are and do; my former tutor, Roy Stuart, for surprising me into realizing that law could be interesting; the Employee Benefits Practice Group at Hodgson Russ LLP; and the editors of the Buffalo Law Review for all their help in preparing this article for publication.

1. Edmund Spenser (1552-1599), Lines on His Promised Pension. When Spenser presented Faerie Queene I-III to Queen Elizabeth I in 1590, she promised him a generous pension, but, according to the Edmund Spenser Homepage, *at* http://www.english.cam.ac.uk/spenser, "her generosity was questioned and moderated by the intercession of Lord Burghley." In February, 1591, Spenser was granted a life pension of £50 per year. *Id.*

INTRODUCTION

A. *The Background*

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA),[2] tax-qualified retirement plans were classified as pension plans, profit-sharing plans, or stock bonus plans. Different rules applied to pension plans, largely because pension plans were viewed as true retirement plans whereas profit-sharing and stock bonus plans were regarded primarily as a way for the employer to share its profits with employees.[3] These basic

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2. Pub. L. 93-406, 88 Stat. 829.

3. According to the pre-ERISA Treasury regulations, which are still in effect, "[a] pension plan . . . is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976). By

conceptual distinctions date back over fifty years.[4] However, over forty-five years ago one leading authority suggested that:

> It is doubtful that the choice of plan in many small companies is dictated by an especial fondness for one of these philosophies over the other; although, to be sure, there are situations where profit-sharing is utilized as an incentive device among categories of salaried employees for whom pensions might have less appeal. Also of relatively minor importance in the choice between pensions and profit-sharing is the desire to provide retirement benefits, as distinguished from deferred benefits realizable before retirement, since the bulk of profit-sharing plans are of the retirement type, differing from pension plans mainly in the basis for making contributions and in the lack of certainty of the amount of the retirement benefit.[5]

Under ERISA, the focus has changed and the most important distinction is now between defined benefit plans and defined contribution plans.[6] All defined benefit plans are pension plans, but defined contribution plans include both pension plans (money purchase or target benefit) and non-pension plans (profit-sharing plans, stock bonus plans, and ESOPs). Despite this change, the pre-ERISA distinctions between defined contribution pension plans and other types of defined contribution plans are still in effect. In addition, legislation enacted and regulations issued since ERISA have created new distinctions, and new types of defined contribution plans.

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contrast, "[a] profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries." *Id.* § 1.401-1(b)(1)(ii). Finally, "[a] stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company." *Id.* § 1.401-1(b)(1)(iii).

4. *See, e.g.*, T.D. 5422, 1944 C.B. 318.

5. Alvin D. Lurie, *Qualified Pension and Profit-Sharing Retirement Plans for Small Companies*, 12 N.Y.U. INST. FED. TAX'N 327, 340 (1954).

6. A defined contribution plan is "a plan which provides for an individual account for each participant and for benefits based *solely* on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." I.R.C. § 414(i) (emphasis added); ERISA § 3(34), 29 U.S.C. § 1002(34) (1994) (emphasis added). A defined benefit plan is "any plan which is not a defined contribution plan." I.R.C. § 414(j); *see also* ERISA § 3(35), 29 U.S.C. § 1002(35).

In addition to the different rules that apply to different types of qualified defined contribution plans, there are other types of defined contribution plans which, though technically not qualified plans, receive tax-favored treatment.[7] Each of these plans is subject to its own set of rules.

All defined contribution plans have the same basic purpose—the accumulation of funds for retirement—and the different rules no longer serve any useful purpose. These differences are a trap for the unwary, and the rules should be harmonized so that, except where different rules are necessitated by the very nature of the plan, all qualified defined contribution plans are subject to the same rules.[8]

Further, the enormous success of 401(k) plans has eliminated the need for tax-sheltered annuity arrangements (also known as 403(b) plans).[9] The best approach would be to repeal section 403(b). If this is not politically possible, then the fallback position would be to harmonize the rules for 401(k) plans and 403(b) plans to eliminate the ludicrous and indefensible differences that exist under current law.[10]

B. *Retirement Plan Coverage*

In at least one respect, ERISA has been a conspicuous failure: the percentage of the private sector workforce covered by any type of retirement plan has stagnated, at

7. *See infra* Part II.E.

8. This article does not address the fact that governmental and church plans are exempted from many of the normal requirements of ERISA and the Internal Revenue Code, as this is a separate and complex topic. *See* I.R.C. § 414(d)-(e) (defining governmental and church plans); ERISA § 3(32)-(33), 29 U.S.C. § 1002(32)-(33); *e.g.*, I.R.C. § 401(a)(11)-(15), (19)-(20) (generally inapplicable to governmental or church plans); ERISA § 4(b)(1)-(2), 29 U.S.C. § 1003(b)(1)-(2) (1994 & Supp. II 1996) (excluding governmental and church plans from coverage under ERISA). The failure to address this issue does not imply an endorsement of these exemptions.

9. According to the U.S. Department of Labor (DOL), 401(k) plans are now one-third of all plans, cover 45% of all active participants, and hold 34% of all assets. 401(k) plans increased by 15% from 1995 to 1996, to 230,800, and other defined contribution plans declined by 5% to 401,800. *See* U.S. DEP'T OF LABOR, PENSION AND WELFARE BENEFITS ADMINISTRATION (PWBA), PRIVATE PENSION PLAN BULLETIN, NO. 9 (1999), *available at* http://www.dol.gov/dol/pwba/public/programs/opr/bullet1996/contents.htm.

10. For a summary of these differences, see *infra* Appendix C.

around 50%, for the last twenty-five years.[11] One Congressional response has been to enact new types of defined contribution plans that are intended for small employers. Thus, we now have employer-sponsored individual retirement accounts (IRAs),[12] simplified employee pension plans (SEPs),[13] salary reduction SEPs (SARSEPs),[14] SIMPLE IRAs,[15] SIMPLE 401(k) plans,[16] and safe harbor 401(k) plans,[17] each of which is subject to a different set of rules, none of which are simple. It is almost impossible, even for a pension maven, to keep all these rules straight, and to advise a client adequately as to which type of plan is best for its business.[18]

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11. In 1997, 71.6% of employees at establishments with 100 or more employees participated in a retirement plan. *See* EMPLOYEE BENEFIT RESEARCH INST., FACTS FROM EBRI: RETIREMENT INCOME PLAN PARTICIPATION, PRIVATE SECTOR, 1996-1997 (1999), *available at* http://www.ebri.org/facts/1199fact.htm. In 1996, only 37.3% of employees at smaller establishments did so. *See id.* The overall percentage for all private sector establishments for 1996-1997 was 53.1%. *See id.* Over the same period, 40.2% participated in a defined contribution plan and 27.1% in a defined benefit plan. *See id.* Many employees participate in both types of plans. *See id; see also* Patrick J. Purcell, Cong. Research Serv., *CRS Summarizes Recent Trends in Pension Coverage and Participation*, TAX NOTES TODAY, Nov. 16, 2000, *at* 2000 TNT 222-24 [hereinafter *CRS Report*] (summarizing recent trends in employee coverage and participation in employer sponsored pension and retirement savings plans). Public-sector workers have traditionally had pension coverage. In 1993, 91% of the 18.6 million federal, state and local employees worked for agencies that sponsored pension plans; 77% percent of all workers were actually covered. *See* American Academy of Actuaries, POLICY MONOGRAPH 1998 NO. 1, *Financing the Retirement of Future Generations: The Problems and Options for Change* 10 (1998), *available at* http://www.actuary.org/pdf/pension/retirement.pdf. In both the public and private sectors, there is a major difference in coverage between part-time and full-time employees. Only 12% of part-time workers in the private sector participate in pension plans, versus 50% of full-time workers. In the public sector, 30% of part-timers were covered in 1993, while 85% of full-time workers were covered. *Id.* A Government Accounting Office (GAO) report found a majority of persons without pension coverage had at least one of the following characteristics: low income, part-time employment, employment at small firms, or youth. *See* GEN. ACCT. OFF., PENSION PLANS: CHARACTERISTICS OF PERSONS IN THE LABOR FORCE WITHOUT PENSION COVERAGE 4 (2000). The GAO report found a strong correlation between having one or more of these traits and either not wanting coverage or being unable to save for retirement. *See id.*

12. *See* I.R.C. § 408(c).

13. *See id.* § 408(k).

14. *See id.* § 408(k)(6).

15. *See id.* § 408(p).

16. *See id.* § 401(k)(11).

17. *See id.* § 401(k)(12).

18. As one author has noted:

The empirical evidence is clear: few small employers understand the variety of available plans, and fewer still have adopted any of them.[19] Nevertheless, the Congressional urge to create new plans has not abated: if the pension reform bill[20] passed by the House in 2000 had been enacted, Roth 401(k) plans and Roth 403(b) plans would have been added to the mix.[21] According to the *2000*

> Even the most erudite pension lawyers seldom have a full view of the landscape of pension laws and regulations. Most likely they are familiar with those rules that apply directly to their own clients. Even Treasury and the IRS have failed to put forward any comprehensive view of this universe for some time partly, I think, because they have formed no firm view of what should be done even if there were no political handcuffs on what they could say.

Gene Steuerle, *Why Pension Simplification is So Difficult to Achieve*, 80 TAX NOTES 253, 254 (1998). The U.S. Department of Labor, the U.S. Small Business Administration, the U.S. Chamber of Commerce, and Merrill Lynch have collaborated on a helpful Web site: select a retirement plan.org, *at* http://www.selectaretirementplan.org (last visited Aug. 1, 2001).

19. According to a recent study involving employers with 5 to 100 full-time workers, 33% of non-sponsors have never heard of SIMPLE plans and another 19% said they were not too familiar with SIMPLE plans. *See* SMALL EMPLOYER RETIREMENT SURVEY, THE 2000 SMALL EMPLOYER RETIREMENT SURVEY (SERS) SUMMARY FINDINGS 3 (2000), *available at* http://www.ebri.org/sers/2000 [hereinafter SERS]. The corresponding numbers for SEPs were 54% and 16%, respectively. *See id.* The survey concluded that:

> [L]ong-term efforts to increase coverage among small employers have the greatest potential for success if they include: education of workers, so that they view retirement planning and saving as a personal priority and communicate their desire for a retirement plan to their employer; ongoing good economic conditions, so that business profits and the affordability of plan sponsorship improve; and policy approaches such as simplification and tax credits that help make plans more affordable.

Id. at 6.

20. *See* Comprehensive Retirement Security and Pension Reform Act, H.R. 1102, 106th Cong. (1999). The bill was also approved unanimously by the Senate Finance Committee on September 7, 2000, but was not voted on by the full Senate. *See* Pension Coverage and Portability Act, S. 741, 106th Cong. (1999); *Bipartisan Senate Pension Bill Attracts Bipartisan Cheers*, TAX NOTES TODAY, Sept. 8, 2000, *at* 2000 TNT 175-2.

21. *See* Pamela Perun & C. Eugene Steuerle, *ALI-ABA Pension Policy Conference ERISA After 25 Years* 4, (ALI-ABA Course of Study Materials, 1999).

> There is a widely-held belief that the key to fixing ERISA is to get more employers to provide a plan, especially a defined benefit plan, for their employees. This is wishful thinking. It has not happened in the last twenty-five years. There are no indications that it will happen in the future in the absence of, and possibly even with, new or different incentives or true regulatory simplification.

Id. at 10.

Small Employer Retirement Survey, the three most frequently cited "most important reasons" for not sponsoring a plan were that: employees prefer wages and/or other benefits (21%); a large portion of employees are seasonal, part-time or high turnover (18%); and revenue is too uncertain to commit to a plan (13%).[22] The three most frequently cited "major reasons" for not doing so were that: revenue is too uncertain (45%); required company contributions are too expensive (43%); and a large portion of employees are seasonal, part-time or high turnover (40%).[23] The factors cited as most likely to influence a small employer to start a plan are: an increase in profits (69%); a tax credit for starting a plan (65%); a plan with reduced administrative requirements (52%); and availability of easy-to-understand information (50%).[24]

For the small employers who do sponsor a plan, the three most commonly cited primary reasons for doing so were: competitive advantage in employee recruitment and retention (35%); positive effect on employee attitude and performance (21%); and that employers have an obligation to provide a plan (13%).[25]

C. *Do We Need Mandatory Private Pensions?*

These persistent gaps in pension plan coverage have led some commentators to conclude that the only way to increase pension coverage significantly is to establish a system of mandatory private retirement plans to supplement Social Security. In 1981, a presidential commission recommended a mandatory minimum pension program for all workers:

> The Commission recommends that a Minimum Universal Pension System (MUPS) be established for all workers. The system should be funded by employer contributions. The Commission further recommends that a 3 percent of payroll contribution be established as a minimum benefit standard.... Vesting of benefits would be immediate.[26]

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22. SERS, *supra* note 19, at 2.
23. *Id.*
24. *Id.* at 5.
25. *Id.* at 3.
26. PRESIDENT'S COMM'N ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 42 (1981).

In 1999, President Clinton proposed a program to supplement Social Security by requiring individual savings accounts that would receive federal matching funds.[27]

In the present political climate, it is highly unlikely that any mandated pension proposal will receive serious consideration. Mandated pensions, like other benefit mandates, are vehemently opposed by small businesses, where most of the gaps in pension coverage exist.[28]

In any event, if additional retirement benefits were to be mandated, it would be far simpler and more cost-effective to increase Social Security benefits, rather than requiring each employer to set up a separate plan to supplement Social Security.[29] In the present climate of hostility toward Social Security, and concern as to how to finance the current benefits, this outcome is extremely unlikely.

D. *The Shift to Defined Contribution Plans*

Over the past fifteen years, there has been a significant trend away from defined benefit plans and toward defined contribution plans, particularly among smaller employers. According to the DOL, the number of private sector defined benefit plans fell from 175,000 in 1983 to 63,700 in 1996, and the number of small defined benefit plans (those with fewer than 100 participants) fell from 149,164 to 47,104.[30]

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27. For a discussion of the proposal, see Pamela Perun, MATCHING PRIVATE SAVING WITH FEDERAL DOLLARS: USA ACCOUNTS AND OTHER SUBSIDIES FOR SAVING, *available at* http://www.urban.org/retirement/briefs/8/brief8.html (Urban Inst., The Retirement Project Series No. 8 1999).

28. *See, e.g*, Frank S. Swain & Lynne L. Garbose, *Mandated Pensions: The Next Hurdle for Small Businesses?*, *in* EMPLOYEE BENEFIT RES. INST., GOVERNMENT MANDATING OF EMPLOYEE BENEFITS 207-08 (1987).

29. This point has been made by Nancy Altman, a critic of mandatory private pensions. *See* Nancy J. Altman, *Rethinking Retirement Income Policies: Nondiscrimination Integration and the Quest for Workers Security*, 42 TAX L. REV. 435, 504 (1987); *see also* Daniel I. Halperin, *Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable As a Means of Increasing Retirement Income? Should It Continue?*, 49 TAX L. REV. 1, 43 (1993).

30. U.S. DEP'T OF LABOR, *supra* note 9; *see also* PWBA Advisory Council, Report of the Working Group on the Merits of Defined Contribution vs. Defined Benefit Plans with an Emphasis on Small Business Concerns, *at* http://www.dol.gov/pwba/public/adcoun/dbrsdc.htm (Nov. 13, 1997) (reporting that the number of defined contribution plans steadily increased from 208,000 in 1975 to 618,500 in 1993); Pension Benefit Guaranty Corporation (PBGC), PENSION INSURANCE DATA BOOK 1996 (1997), *available at* http://www.pbgc.gov/

There has been a similar shift in plan assets. In 1975, total defined benefit plan assets were $186 billion, more than twice the total defined contribution assets of $74 billion. In 1996, defined benefit plan assets had increased to $1.6 trillion, but defined contribution assets had increased to $1.5 trillion.[31] Over the same period, annual contributions to defined benefit plans increased by 50%, from $24 billion to $36 billion, but contributions to defined contribution plans increased by over 900%, from $13 billion to $134 billion.[32]

E. *The Need for Simplification*

The Joint Committee on Taxation ("JCT") has stated recently that the federal pension laws "are recognized as among the most complex set of rules applicable to any area of the tax law,"[33] and that:

> The number of different tax-favored retirement arrangements increase complexity in the pension rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model pension plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.[34]

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publications/databooks/databk96.pdf (reporting that the number of single-employer defined benefit plans covered by PBGC fell from 112,000 in 1985 to 47,000 in 1996).

31. *See CRS Report*, *supra* note 11, para. 26.

32. *See id.*

33. Joint Comm. on Tax'n, *Overview of Present Tax Law Rules Relating to Qualified Pension Plans* (1998), TAX NOTES TODAY, May 5, 1998, *at* 98 TNT 86-21 [hereinafter *Qualified Pension Plans*].

34. Joint Comm. on Tax'n, *Overview of Present Law and Issues Relating to Employer-Sponsored Retirement Plans*, BNA DAILY TAX REP., Mar. 23, 1999, *available at* WL 55 DTR L-5 (1999) [hereinafter *Employer-Sponsored Retirement Plans*]. This point is echoed by Eugene Steuerle:

> Do we need both traditional IRAs and Roth IRAs, both profit-sharing and employee stock option plans, both money purchase and profit-sharing plans, both 401(k) and 403(b) plans? My feeling is that the gains from these differentiations are small, if any, and the costs of administration are almost inevitably higher than any gains.

Steuerle, *supra* note 18, at 253.

The JCT has identified the following barriers to pension simplification:[35] (1) the volume and frequency of employee benefits legislation;[36] (2) developments and changes in the structure of the workforce, including large employers that have separate entities or operating units and different categories of employees; (3) the employers' desire for flexibility (the report also suggests that employers who wish to reduce complexity can adopt a master or prototype plan or a simple profit-sharing plan; this is misleading, because even these relatively simple plans are subject to complex rules); (4) the need for certainty as to how the rules actually operate; (5) conflicts between retirement policy and tax policy;[37] (6) divided jurisdiction both in Congress and in

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35. *Qualified Pension Plans*, *supra* note 33. The report also suggests that the following factors should be considered in evaluating any simplification proposal:

> (1) the extent to which the proposed change is consistent with the underlying policy objective of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and "grandfather" rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

Id.

36. This is undeniable: since the enactment of ERISA in 1974, I.R.C. § 401, which contains the basic plan qualification rules, has been substantively amended by fifteen separate statutes. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763; Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324; Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494; Retirement Equity Act of 1984, Pub. L. No. 98-397, 98 Stat. 1426; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, 101 Stat. 1330; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106; Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, 106 Stat. 290; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312; Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788. Many of these changes had nothing to do with good pension policy, but were revenue-driven.

37. With respect to these conflicts, the JCT states:

> [R]etirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan. . . . [T]ax policy requires a balancing of the

the executive branch; and (7) transition rules and grandfather rules.

Gene Steuerle has identified two major obstacles to pension simplification:

> First, the issues are so complex that almost no one comprehends all of them well. Second, removal of any option almost inevitably is going to offend someone. The two obstacles are closely related, and the net result is a powerful momentum to maintain the status quo, perhaps provide some additional options, but seldom to simplify if it means reducing almost any option whatsoever.[38]

I advocate a solution that is simpler to state than to achieve: one set of rules that is essentially uniform for all types of qualified defined contribution plans including, if they are retained, 403(b) plans.[39] In addition, I recommend a single type of plan that would be available only to small businesses, and that could be either a qualified plan or a type of IRA.[40] In doing so, I do not underestimate the

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> tax benefits provided to an employer who maintains a qualified plan in relation to all other tax subsidies provided by the Federal tax laws. This balancing has led Congress to: (1) limit the total amount of benefits that may be provided to any one employee by a qualified plan, and (2) adopt strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified pension plans.

See Employer-Sponsored Retirement Plans, *supra* note 34.

38. Steuerle, *supra* note 18, at 253-54.

39. A 1989 New York State Bar Association Committee described a simplified baseline-plus-supplemental pension. *See* N.Y. State Bar Ass'n Special Comm. on Pension Simplification, *A Process Awry: Federal Pension Laws*, 43 TAX NOTES 463, 473-74 (1989); *see also* Douglas Ell, *Perspective—The "Perfect" Retirement Plan*, 12 BENEFITS L.J. 45 (1999) (describing the provisions of the "perfect" retirement plan). The pension reform legislation passed by the House in 2000, *see supra* note 20 and accompanying text, would have done little or nothing to simplify the current rules. For a criticism of the bill, see Daniel Halperin, *Why Pension Reform Legislation Is a Bad Idea*, TAX NOTES TODAY, Nov. 10, 2000, *at* 2000 TNT 220-31.

40. Perun and Steuerle make a similar proposal:

> At the heart of the proposal is the creation of a single, standard form of defined contribution plan. It would replace the multiple plan types now available as well as the separate, "simplified", set of plans for small employers. Such a plan is feasible because, now that contributions to profit-sharing plans no longer depend on employer profits, the historical rationale for maintaining separate money purchase, stock bonus and profit-sharing plans no longer exists. The principle [sic] remaining differences among the plans are whether the formula is fixed or discretionary, what spousal rights attach to benefits, what limit on deductible contributions should apply, and how benefits may

strength of the barriers described above. However, I believe that, if the existing legal framework is reviewed dispassionately, and with no undue reverence for the sanctity of any of the rules, we will find that considerable simplification can be achieved without sacrificing important principles. This dispassionate review cannot, in my opinion, be performed by Congress in the current legislative climate.

Pension coverage is closely correlated with employer size: in general, smaller employers are significantly less likely to offer a plan than larger employers. Accordingly, this article also suggests some areas in which the current rules that apply to all defined contribution plans could be simplified, as studies indicate that complexity is one of the factors that discourages small employers from adopting a plan.[41]

Finally, I recommend the establishment of a federal pension commission[42] to study the private retirement system and to make recommendations to Congress for

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> be distributed, that is, in cash or in stock. These are not difficult design issues. It should be relatively easy to compromise on a standard form of plan with sufficient flexibility to be attractive to small and large employers alike.

Perun & Steuerle, *supra* note 21, at 11-12.

41. There is substantial literature discussing pension complexity and the need for simplification. *See, e.g., Eliminate Pension Gridlock by Simplifying the Rules, Says APPWP Report*, TAX NOTES TODAY, Oct. 20, 1989, *at* 89 TNT 213-24 (recommending twenty-nine specific simplifications of the law); *Qualified Pension Plans*, *supra* note 33; *Employer-Sponsored Retirement Plans*, *supra* note 34; David A. Pratt & Dianne Bennett, *Simplifying Retirement Plan Distributions*, *in* 57 N.Y.U. INST. FED. TAX'N, EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION 5 (1999); N.Y. State Bar Ass'n, *supra* note 39 (including a list of those areas most in need of simplification); Steuerle, *supra* note 18; Mark J. Warshawsky, *Minimum Distribution Requirements: Reform or Remove Them*, 81 TAX NOTES 1133 (1998). *See generally* David J. Kautter, *Employee Benefits: Statutory Simplification*, 18 TAX MGMT. COMP. PLAN. J. 51 (1990); 2 JOINT COMM. ON TAX'N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, *at* 149-602 (Comm. Print 2001).

42. I make this recommendation with some hesitation, given the failure of the 1994-1996 Social Security Advisory Council and the Medicare Reform Commission to reach a consensus, still less to result in reform legislation. However, I believe that it is essential that Congress act to strengthen the private pension system, as an essential complement to Social Security, and I believe that a commission is more likely to result in coherent reforms than the piecemeal legislation we have seen over the last twenty years, particularly when the latter is driven primarily by budgetary considerations, rather than by sound pension policy.

maintaining and improving the retirement security of all Americans. The first priorities for the commission would be to study how to encourage small businesses to adopt plans and how to improve the pension coverage of lower income workers. As part of that study, the commission would make recommendations for (1) the design of the new small business plan, and (2) incentives to encourage individuals to save for their retirement, either through an employer plan or on their own.[43]

I. THE LEGAL BACKGROUND: ERISA AND THE CODE

A. *In General*

The Internal Revenue Code (the "Code") provides favorable tax treatment for "qualified" retirement plans maintained by an employer. The employer's contributions are currently deductible (within limits) for income tax purposes;[44] the employee is not currently taxed on the contributions made on his or her behalf;[45] and the trust which holds the plan assets is tax-exempt.[46] In order to qualify for these tax benefits, the plan must satisfy detailed

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43. An independent pension law commission was recommended by the New York State Bar Association Committee. *See* N.Y. State Bar Ass'n, *supra* note 39, at 463 ("The principal charges to this commission would be the enunciation of a national retirement income policy and the development of a pension revision act to replace the present laws."). In late 2000, Senator Bingaman (D-N.M) introduced the Pension Reform and Simplification Act, providing for such a commission. *See Sen. Bingaman Seeks Support for Pension Commission Bill*, TAX NOTES TODAY, Nov. 2, 2000, *at* 2000 TNT 213-31.

44. *See* I.R.C. § 404. [Citations to the Internal Revenue Code throughout are to the Code as amended through April 2001, unless otherwise noted.—Eds.]

45. *See id.* § 402(a). The employee is generally not taxed until he or she actually receives benefits from the plan. *See id.* Even at that stage, most retirement plan distributions (other than annuities or long-term installment payments) can be "rolled over" to another qualified plan or to an individual retirement account which defers taxation until distributions are received from the transferee plan. *See id.* § 402(c). For further details, see *infra* Part VII.C.

46. *See* I.R.C. § 501(a). For fiscal year 1999, the tax expenditure for the net exclusion for pension contributions and earnings was estimated to be $76.1 billion. *See* JOINT COMM. ON TAX'N, 105TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1999-2003, at 23 (Comm. Print 1998). For fiscal year 2000, the tax expenditure for the net exclusion for pension contributions and earnings is estimated to be $93.2 billion. JOINT COMM. ON TAX'N, 106TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2000-2004, at 23 (Comm. Print 1999).

qualification requirements set out in the Code;[47] the term "qualified plan" simply means a plan that satisfies those requirements. The retirement plan rules of the Code apply only to qualified plans,[48] and to certain other retirement arrangements defined in the Code which, though not technically qualified plans, receive tax-favored treatment provided that they satisfy the specific rules to which they are subject.[49]

ERISA, by contrast, applies to all "pension plans" unless there is a statutory or regulatory exemption.[50] Under ERISA, the term "pension plan" is broadly defined to include:

> any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program:
>
> (i) provides retirement income to employees, or
>
> (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.[51]

Three points should be noted. First, ERISA only applies to plans established or maintained by an employer and/or by an employee organization, generally a union.[52] Second, arrangements which essentially result in additional cash compensation (such as stock options, bonus plans and short

47. *See* I.R.C. § 401(a).

48. By contrast, the term "nonqualified plan" refers to a plan that is not intended to satisfy the qualification requirements. *See* BRUCE MCNEIL, NONQUALIFIED DEFERRED COMPENSATION PLANS 1 (2001). These plans are generally designed to provide additional benefits to highly paid executives, *see id.*, and are not discussed further in this article.

49. These other arrangements include annuity plans described in I.R.C. § 403(a), tax-sheltered annuity arrangements described in I.R.C. § 403(b), individual retirement accounts (IRAs), described in I.R.C. § 408, simplified employee pension plans (SEPs) described in I.R.C. § 408(k), SIMPLE IRAs described in I.R.C. § 408(p) and eligible deferred compensation plans described in I.R.C. § 457(b). *See infra* Part II.E.

50. ERISA § 4(a), 29 U.S.C. § 1003(a) (1994).

51. *Id.* § 3(2), 29 U.S.C. § 1002(2).

52. *Id.* § 3(1)-(2), 29 U.S.C. § 1002(1)-(2).

or long term incentive plans) are generally not subject to ERISA, even if the payout is deferred.[53] Third, though almost all employers are required to pay the employment taxes that finance Social Security and Medicare, no employer is required to provide retirement benefits to its employees.[54]

ERISA and the Code regulate the design and administration of retirement plans, but do not mandate the type or amount of benefits that are provided. Accordingly, while the statutes provide minimum standards with which plans must comply, it is essential to read the plan documents to determine an employee's rights under a particular plan.

B. *ERISA Exemptions*

ERISA exempts various categories of retirement plans from its coverage. The most important exemptions are as follows. The first exception is governmental plans, which include (1) plans established or maintained for employees by the federal government, by any state government or political subdivision (such as a county or city) or by any agency or instrumentality thereof, (2) any plan that is governed by the Railroad Retirement Act, and (3) any plan of a tax-exempt international organization (such as the United Nations).[55] Thus, for instance, the various retirement programs maintained by the states for public sector employees (civil servants, teachers, police and firefighters) are not subject to ERISA, and are governed primarily by state law.

The second important exception is church plans, a term that is wider than it appears, as it extends to plans maintained by certain church- associated organizations such as hospitals.[56]

53. Employee welfare plans (such as group health plans, group life insurance and group disability insurance) are also subject to ERISA, but are not discussed in this article.

54. Thus, about 96% of American workers are covered by Social Security and over 90% of public sector employees are covered by a retirement plan, but only about 50% of private sector employees are covered. *See supra* note 11 and accompanying text.

55. ERISA §§ 3(32), 4(b)(1), 29 U.S.C. §§ 1002(32), 1003(b)(1) (1994 & Supp. II 1996).

56. *Id.* §§ 3(33), 4(b)(2), 29 U.S.C. §§ 1002(33), 1003(b)(2).

Finally, plans maintained solely for the purpose of complying with applicable workmen's compensation, unemployment compensation, or disability insurance laws are also exempt.[57]

The DOL regulations provide additional exemptions and clarifications of the scope of ERISA coverage. Thus, the regulations exempt (1) a plan that covers only self-employed individuals (partners, sole proprietors or members of a limited liability company), because it does not cover any employees,[58] and (2) a tax-sheltered annuity arrangement under Code section 403(b), if the only contributions are made by employees and the employer's involvement is limited.[59]

The tax advantages of qualified plans are not important to governmental and tax-exempt employers, but their plans must generally comply with the Code's qualification requirements in order to secure the desired tax advantages (such as deferral of tax on employer contributions) for their employees. However, governmental and church plans are exempted from some of the normal qualification requirements.[60]

C. *ERISA and Other Laws*

ERISA provides substantive rights for individuals who are entitled to benefits under a retirement plan that is subject to ERISA. These rights can be enforced either by the individual or by the DOL on the employees' behalf.[61] Many of the ERISA provisions also appear in the Code; however, there is no individual right of action for violations of the Code. The Code's requirements are enforced exclusively by the Internal Revenue Service (IRS) which has available an extensive array of enforcement tools including, in an extreme case, disqualification of the plan. An individual who feels that his or her rights are being violated may complain either to the DOL or the IRS which,

57. *Id.* § 4(b)(3), 29 U.S.C. § 1003(b)(3); *see also* Shaw v. Delta Airlines, Inc., 463 U.S. 85, 87 (1983) (stating that exclusion does not apply to plans that provide other benefits as well as state-mandated disability benefits).

58. 29 C.F.R. § 2510.3-3(b) (2001).

59. *Id.* § 2510.3-2(f).

60. *See supra* note 8 and accompanying text.

61. ERISA § 502, 29 U.S.C. § 1132 (1994 & Supp. III 1997); *see also id.* § 504, 29 U.S.C. § 1134 (conferring broad investigative authority on the DOL).

if it concludes that the complaint has merit, will often pressure the employer to resolve the employee's complaint.

One of the most controversial provisions of ERISA is the preemption clause which provides that, subject to certain exceptions, ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title and not exempt under section 1003(b) of this title."[62]

The early Supreme Court decisions under ERISA interpreted this preemption provision very broadly.[63] Although the Supreme Court has retreated somewhat in recent cases, it has never overruled its early decisions and, despite six Supreme Court decisions in the last six years,[64] the scope of ERISA preemption remains unclear. If a cause of action under state law is preempted by ERISA, then the plaintiff may not pursue that cause of action, even if: (1) there is no cause of action under ERISA, or (2) the remedies under state law are more extensive than those under ERISA. ERISA does not preempt federal laws[65] so, for instance, an ERISA-covered plan must comply with federal age and sex discrimination laws.

II. TYPES OF RETIREMENT PLANS

In general, any employer is free to adopt any of the different types of plans discussed in this article. However, there are exceptions: (1) Certain governmental employers may not adopt a 401(k) plan;[66] (2) SIMPLE IRAs and SIMPLE 401(k) plans are available only to small

62. ERISA § 514(a), 29 U.S.C. § 1144(a) (1994).

63. *See, e.g.*, Shaw v. Delta Airlines, Inc., 463 U.S. 85 (1983); Ingersoll-Rand Co. v. McClendon, 498 U.S. 133, 139 (1990) ("[A] state law may 'relate to' a benefit plan, and thereby be pre-empted, even if the law is not specifically designed to affect such plans, or the effect is only indirect. Preemption is also not precluded simply because a state law is consistent with ERISA's substantive requirements.") (citations omitted).

64. N.Y.S. Conf. of Blue Cross and Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645 (1995); California Div. of Labor Standards Enforcement v. Dillingham Constr., N.A., Inc., 519 U.S. 316 (1997); De Buono v. NYSA-ILA Med. and Clinical Serv. Fund, 520 U.S. 806 (1997); Boggs v. Boggs, 520 U.S. 833 (1997); UNUM Life Ins. Co. of America v. Ward, 526 U.S. 358 (1999); Egelhoff v. Egelhoff, 121 S. Ct. 1322 (2001).

65. ERISA § 514(d), 29 U.S.C. § 1144(d).

66. *See infra* text accompanying note 86.

employers;[67] (3) an ESOP or stock bonus plan can only be adopted by an employer which issues, or is a member of the same controlled group of corporations as a company which issues, employer securities;[68] (4) a tax-sheltered annuity program under section 403(b) can be adopted only by a public educational institution or by a private organization that is tax-exempt under section 501(c)(3);[69] (5) an eligible deferred compensation plan under section 457(b) may be adopted only by a governmental employer or by a private tax-exempt organization (other than a church).[70]

A. *Defined Contribution Plans*[71]

Under a defined contribution plan, all amounts contributed to the plan on behalf of an employee are credited to one or more accounts in his or her name. For instance, under a 401(k) plan that provides for (1) elective, pre-tax deferrals by employees, (2) employer matching contributions, and (3) additional employer discretionary contributions, each plan participant would generally have three separate accounts, one for each type of contribution.

The amount of the benefits payable by the plan is determined *solely* by reference to the then value of the participant's accounts, namely the sum of: (1) all employer contributions made to the plan on his or her behalf; (2) any employee contributions which he or she has made; (3) forfeitures, resulting from the termination of employment of other plan participants before they are fully vested; and (4) his or her share of the plan's investment earnings or losses.

Accordingly, under a defined contribution plan, *no specific level of benefits is promised to the employee* and the employee is directly affected by the success or otherwise of the plan's investments.

Generally, a defined contribution plan cannot be underfunded or overfunded: the total value of all participants' accounts is equal to the total value of the plan assets. Asset values are updated at least annually. Under many plans, values are updated monthly or quarterly, and a significant number of plans provide for daily valuations.

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67. *See infra* text accompanying notes 101, 174.
68. *See infra* text accompanying notes 507-509.
69. *See infra* text accompanying note 145.
70. *See infra* text accompanying note 179.
71. I.R.C. § 414(i); ERISA § 3(34), 29 U.S.C. § 1002(34) (1994).

B. *Defined Benefit Plans*

Under the statutes, any plan which is not a defined contribution plan (because the benefit is not based *solely* on the value of the participant's account) is classified as a defined benefit plan.[72] Defined benefit plans vary widely since the definition embraces numerous different plan designs.

Under a traditional defined benefit plan, the plan itself specifies the benefit which will be payable on termination of employment. This is typically a function of (1) average salary over a period of years specified in the plan and (2) the length of the employee's service. For instance, the plan could provide that at age sixty-five, the employee will receive a monthly pension for life equal to 50% of final average salary (over the period of five or ten consecutive years which would produce the highest average), reduced proportionately if he or she has less than twenty-five years of service.

Under a traditional defined benefit plan, there are no individual accounts for employees. Instead, the plan retains an actuary to calculate the amount which will be required at the employee's retirement date in order to provide the specified benefit. The amount required at retirement will depend on (1) the amount of the annual pension, (2) an assumption as to the income the plan will earn on its investments, in the post-retirement period, (3) an assumption as to mortality, namely the length of time that a participant will survive, and continue to receive benefits, after retirement, and (4) the form in which the benefit is paid (for example, single life annuity or joint and survivor annuity).

The annual deposit required for each participating employee will depend on: (1) the employee's age (the younger the employee, the longer the period available to fund the benefit and, accordingly, the less the annual deposit will be); (2) an assumption as to the investment income the plan will earn in the pre-retirement period; (3) an assumption as to the rate at which the employee's salary will increase between now and retirement; and (4) an assumption as to employee turnover and pre-retirement mortality.

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72. I.R.C. § 414(j); ERISA § 3(35), 29 U.S.C. § 1002(35).

C. *Hybrid Plans*[73]

In recent years, new plan designs have been developed, in response to the fact that traditional defined benefit and defined contribution plans all have certain disadvantages. For instance, a traditional defined benefit plan provides a definite level of benefits, and the employee does not bear any of the investment risk. However, defined benefit plans provide very small benefits for younger, short service employees, are difficult to understand and are complex to administer. A traditional defined contribution plan is relatively easy to communicate to employees, and allows employees to benefit from good investment results. However, the employee has little or no protection against poor investment performance, and the plan may simply not accumulate sufficient assets by the employee's retirement, particularly if the employee is not covered by the plan until later in his or her career.

Hybrid plans have some defined benefit features and some defined contribution features. The most common type of hybrid plan is also the most controversial, the cash balance plan. A cash balance plan is a defined benefit plan because it guarantees a minimum benefit. However, the plan also provides for a hypothetical account balance, a hypothetical annual contribution for each participant, and hypothetical interest on those contributions. The employee receives the greater of the defined benefit or the hypothetical account balance. In recent years, numerous large companies (most notoriously, IBM) have converted traditional defined benefit plans to cash balance plans, and this practice has become very controversial.

D. *Types of Qualified Defined Contribution Plans*[74]

1. *Profit-Sharing Plan.* Under prior law, contributions to a profit-sharing plan could only be made from current or

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73. *See* ERISA Advisory Council, Report of the Working Group Studying the Trend in the Defined Benefit Market to Hybrid Plans, *available at* http://www.dol.gov/dol/pwba/public/adcoun/cbalinfo.htm (Nov. 10, 1999); *see also Employee Benefit Research Institute, Hybrid Retirement Plans: The Retirement Income System Continues to Evolve* (Issue Brief No. 171, 1996), *available at* http://www.ebri.org/ibex/ib171.htm.

accumulated profits.[75] Contributions to a profit-sharing plan may now be made even if the employer has no profits or is a tax-exempt entity.[76] If the plan is intended to be a profit-sharing plan, the plan must designate "such intent at such time and in such manner as the Secretary may prescribe."[77]

Contributions to a profit-sharing plan are generally discretionary: each year, the board of directors of the employer decides whether to make a contribution to the plan and, if so, how much to contribute.[78] This flexibility is a major advantage from the employer's point of view, as it means that there is no commitment to contribute in unprofitable years.[79] From the employee's point of view, there is no certainty as to how much will be contributed in any year. If a contribution is made, it is generally allocated among participating employees in proportion to salaries for the year in question.

A recent variation of the traditional profit-sharing plan is a new comparability plan, under which the allocation is based on employee classification as well as salary.[80] This can enable the employer to make larger contributions (as a percentage of compensation) for key employees, while retaining the flexibility of the traditional profit-sharing plan.[81]

74. According to the DOL, in 1996 there were 63,657 defined benefit plans and 632,566 defined contribution plans, made up as follows: 497,173 profit-sharing/thrift plans; 4612 stock bonus plans; 5905 target benefit plans; 98,875 money purchase plans; 13,695 section 403(b)(1) plans; 1210 section 403(b)(7) plans; 787 IRAs; and 10,310 "Other" plans. *See* U.S. DEP'T OF LABOR, *supra* note 9, at tbl.A1.

75. Treas. Reg. § 1.401-1(b)(1)(ii), (2) (as amended in 1976).

76. *See* I.R.C. § 401(a)(27)(A).

77. *Id.* at § 401(a)(27)(B).

78. Before July 2, 1956, the regulations required a profit-sharing plan to contain a definite pre-determined formula for determining the amount of the profits to be shared. The IRS then abandoned its position because the courts refused to sustain it. *See* Treas. Reg. § 39.165-1(a)(2); *see also* Walter A. Slowinski, *Profit-Sharing Plans for Small Companies*, 15 N.Y.U. INST. ON FED. TAX'N, EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION, 1099, 1106 (1957).

79. Unpredictability of future profits is the reason cited most frequently by small employers for not establishing a retirement plan. *See supra* notes 22-23 and accompanying text. However, the regulations require profit-sharing plan contributions to be "recurring and substantial." *See* Treas. Reg. § 1.401-1(b)(2) (1976).

80. *See infra* Part II.D.7.

81. The nondiscrimination rule for qualified plans, *see* I.R.C. § 401(a)(4) (which has no counterpart in ERISA), merely requires that either the contributions or the benefits under the plan not discriminate in favor of highly

2. *401 (k) Plan.*[82] A 401(k) plan is a profit-sharing plan with one additional feature, namely the ability of individual employees to elect to have contributed to the plan, on their behalf, a portion of the salary or bonus which would otherwise be paid to them in cash.[83] If they do so, and if the rules of Code section 401(k) are met, then no income tax is payable on the amount deferred by the employee until benefits are paid by the plan. Such amounts do, however, remain subject to employment taxes.[84] Once the employee has made the election to defer, the salary reduction contributions are treated for all purposes, including deduction limitations, as employer contributions. For 2001, the maximum salary deferral is $10,500; this maximum is adjusted annually for inflation.[85]

The Tax Reform Act of 1986, as amended, generally precludes the adoption of a new 401(k) plan by any state or local government or political subdivision thereof, or any agency or instrumentality thereof.[86] Public educational institutions, but not other government employers, are allowed instead to sponsor a tax-sheltered annuity (TSA)

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compensated employees. Under a typical new comparability plan design, the contributions would not satisfy this requirement, but by projecting contributions to normal retirement age, the employer can use the cross-testing rules, *see* Treas. Reg. § 1.401(a)(4)-8 (as amended in 2001), to establish that the projected benefits are not discriminatory.

82. I.R.C. § 401(k) was enacted by the Revenue Act of 1978, Pub. L. No. 95-600, Title I § 135(a), 92 Stat. 2765, 2785 (1985). However, cash or deferred profit-sharing plans existed before ERISA. *See, e.g.*, Rev. Rul. 56-497, 1956-2 C.B. 284 (declared obsolete by Rev. Rul. 80-16, 1980-1 C.B. 82). Appendix C summarizes the major characteristics of 401(k) plans and other types of plan that allow pre-tax employee deferrals.

83. It is also possible to include an employee deferral election, or CODA (cash or deferred arrangement), in a stock bonus plan, pre-ERISA money purchase pension plan, or rural cooperative plan. *See* I.R.C. § 401(k)(1) (1994). However, almost all CODAs are part of profit-sharing plans. The 1997 DOL Working Group Report recommended that the law be amended to allow pre-tax elective deferrals under a defined benefit plan. PWBA Advisory Council, *supra* note 30.

84. I.R.C. §§ 3121(v)(1) (Federal Insurance Contributions Act), 3306(r)(1) (Federal Unemployment Tax Act).

85. *See id.* §§ 401(a)(30), 402(g)(1), (5); *see also* I.R.S. Notice 2000-66, 2000-1 C.B. 600.

86. I.R.C. § 401(k)(4)(B). There is a grandfather rule for plans adopted before May 6, 1986. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, Title XI § 1116(f), 100 Stat. 2085, 2457 (1986). This prohibition does not apply to a rural cooperative plan, as defined in I.R.C. § 401(k)(7), or to a plan of an Indian tribal government described in § 401(k)(4)(B)(iii).

program under section 403(b) of the Code. Alternatively, a governmental employer may sponsor an eligible deferred compensation plan under section 457(b). Employees may make tax deductible contributions to a 403(b) or 457(b) plan.[87]

401(k) plans are generally subject to special nondiscrimination tests. Under the actual deferral percentage (ADP) test,[88] the amount by which (1) the average rate of elective deferrals (and certain amounts that are treated as elective deferrals) for the group of "highly compensated employees" (HCEs)[89] may exceed (2) the average rate of deferrals for the group of "non-highly compensated employees" (NHCEs) is limited.[90] A similar test, the actual contribution percentage (ACP) test, applies to employer matching contributions and after-tax employee contributions.[91] Finally, the plan must satisfy a complex "multiple use" test.[92]

Recent legislation has added two variations of the traditional 401(k) plan, the safe harbor 401(k) plan and the SIMPLE 401(k) plan, that are generally treated as satisfying the discrimination tests on the basis of plan design, without the need to perform the tests.

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87. I.R.C. § 402(e)(3). For further details, see discussion *infra* Parts II.E.1, II.E.4. In the case of a public employer that does not have a grandfathered 401(k) plan, and that is not an educational institution, the only type of retirement plan to which voluntary pre-tax employee contributions can be made is an eligible deferred compensation plan. Mandatory employee contributions to public sector retirement plans may be "picked-up" by the employer. *See* I.R.C. § 414(h). The effect is that the amount contributed is excluded from the employee's federal gross income, but it is often included in gross income for State income tax purposes.

88. I.R.C. § 401(k)(3).

89. Essentially, an HCE is any person who (1) earned at least $80,000 (indexed) from the employer during the preceding year (and, if the employer so elects, was among the highest paid 20% of employees) or (2) owned, directly or by attribution (for instance, from a family member), more than 5% of the employer at any time during the current or preceding year. *Id.* § 414(q)(1)(B)(i). Any plan participant who is not an HCE is an NHCE.

90. *See id.* § 401(k)(3).

91. *See id.* § 401(m)(2).

92. *Id.* § 401(m)(9); Treas. Reg. § 1.401(m)-2 (as amended in 1994). Characteristically, the federal government exempted its own 401(k) plan, the Federal Employees' Thrift Plan, from the ADP and ACP tests, convincing Congress that the dollar limit on elective deferrals adequately limited the benefits available to HCEs. *See Eliminate Pension Gridlock, supra* note 41. Also, under an amendment enacted in 1997, state and local government 401(k) plans are treated as satisfying the ADP test. *See* I.R.C. § 401(k)(3)(G).

a. *Safe Harbor 401(k) Plan.*[93] Code sections 401(k)(12) and 401(m)(11), enacted in 1996, provide for a design-based safe harbor 401(k) plan: if the plan satisfies either of two contribution requirements and also a notice requirement, then it is treated as satisfying the ADP and ACP tests.[94]

The employer must make a matching contribution, on behalf of each NHCE, equal to 100% of his or her elective contributions up to 3% of compensation, plus 50% of the elective contributions in excess of 3%, but not in excess of 5%, of compensation. The plan may provide for an alternative matching contribution formula, provided that (1) the rate of matching contributions does not increase as the rate of elective contributions increases, (2) the total matching contribution, at any level of elective contributions, is at least equal to the amount provided by the statutory formula and (3) matching contributions are not made with respect to employee contributions or elective deferrals in excess of 6% of compensation. Finally, the rate of matching contribution for any HCE, at any rate of elective contributions, must not be greater than the rate for any NHCE.[95]

Instead of providing a matching contribution, the employer may make a contribution to a defined contribution plan, on behalf of each eligible NHCE, equal to at least 3% of the NHCE's compensation.[96]

The required safe harbor contribution (matching or nonelective) must be subject to the same withdrawal restrictions as apply to elective deferrals under any 401(k) plan,[97] and must be fully vested when made.[98] The employer contribution can be made either to the safe harbor plan, or to any other plan maintained by the employer.[99]

Within a reasonable period before any year, each eligible employee must be given written notice of the

93. The IRS has issued guidance that supplements the statutory rule. *See* I.R.S. Notice 98-52, 1998-2 C.B. 634; I.R.S. Notice 2000-3, 2000-1 C.B. 413; *see also* Paula A. Calimafde & Deborah A. Cohn, *401(k) Safe Harbors Work for Small Business*, 58 N.Y.U. INST. FED. TAX'N, EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION, at 2-1 (2000); *ABA Tax Section Details Unresolved Issues on 401(k) Safe Harbors*, TAX NOTES TODAY, Dec. 21, 2000, *at* 2000-TNT 246-66.

94. I.R.C. §§ 401(k)(12)(A), 401(m)(11)(A).

95. *Id.* §§ 401(k)(12)(B), 401(m)(11)(B).

96. *Id.* § 401(k)(12)(C).

97. *Id.* § 401(k)(2)(B), (C).

98. *Id.* § 401(k)(12)(E)(i).

99. *Id.* § 401(k)(12)(F).

employee's rights and obligations under the arrangement, which (1) is sufficiently accurate and comprehensive to apprize the employee of those rights and obligations, and (2) is written in a manner calculated to be understood by the average eligible employee.[100]

b. *SIMPLE 401(k) Plan.* A SIMPLE 401(k) plan may only be maintained by an eligible employer,[101] namely one that, for the preceding year, had no more than 100 employees who received at least $5000 of compensation from the employer. The employer aggregation rules of section 414 apply. However, there is a grace period for previously eligible employers that exceed this limit.[102]

A SIMPLE 401(k) plan is treated as satisfying the ADP and ACP tests[103] if the following requirements are satisfied. First, the plan must satisfy the contribution requirements of section 401(k)(11)(B). Employees must be allowed to defer up to $6000 per year, and the employer must either (a) match employee deferrals, dollar for dollar, up to 3% of compensation or (b) make a 2% nonelective contribution. The $6000 limit is adjusted for cost of living increases, and is $6500 for 2001.[104] No other contributions may be made to the plan.[105]

Second, the employee must be allowed to terminate participation at any time during the year. The plan may provide that the employee may not resume participation until the beginning of the following year.[106]

Third, the employer must notify each eligible employee, within a reasonable period of time before the sixtieth day before the beginning of the year (and, for the first year, the sixtieth day before the employee is first eligible) of the employee's right to elect to participate.[107] Each eligible employee may elect, during the sixty day period before the beginning of any year (and during the sixty day period before the employee is first eligible to participate), to

100. *Id.* § 401(k)(12)(D).
101. *Id.* §§ 401(k)(11)(A), 408(p)(2)(A), (C).
102. *Id.* § 408(p)(2)(C)(ii), (p)(10).
103. *Id.* § 401(k)(11) and (m)(10).
104. *Id.* § 401(k)(11)(E).
105. *Id.* § 401(k)(11)(B).
106. *Id.* §§ 401(k)(11)(B)(iii)(I), 408(p)(5)(B).
107. *Id.* § 401(k)(11)(B)(iii)(II).

participate or to modify the amounts subject to the arrangement for the year.[108]

Fourth, the plan must satisfy the exclusive plan requirement: for the year being tested, no contributions may be made, or benefits accrued, for services during the year under any "qualified plan"[109] of the employer on behalf of an employee eligible to participate in the plan, other than the contributions described above.[110]

Finally, all contributions must be vested, and withdrawals by the employee must be permitted at any time.[111]

If the plan allows only the contributions described above, the plan will not be treated as a top-heavy plan.[112]

3. *Stock Bonus Plan.* A stock bonus plan is essentially a specialized type of profit-sharing plan, under which contributions are made in employer stock or, if made in cash, are then invested, wholly or partly, in employer stock. Most ESOPs are structured as stock bonus plans. Generally, benefits from stock bonus plans must be distributable in the form of employer stock.[113]

4. *ESOP.* In the 1970s and 1980s, much favorable legislation was passed with a view to encouraging Employee Stock Ownership Plans (ESOPs).[114] An ESOP is a defined contribution plan which: (1) is a qualified stock bonus plan, or a combination of a stock bonus plan and a money purchase plan, both of which are qualified, and which is designed to invest primarily in qualifying employer securities; (2) is otherwise defined in regulations; and (3) satisfies the requirements of Code sections 409(h), 409(o),

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108. *Id.* §§ 401(k)(11)(B)(iii)(I), 408(p)(5)(B)-(C).

109. For this purpose, the term "qualified plan" includes a qualified plan, an annuity plan described in I.R.C. § 403(a), a governmental plan, a section 403(b) plan, a SEP, a SIMPLE plan or section 501(c)(18) trust. *See id.* §§ 401(k)(11)(C), (D)(i), 408(p)(2)(D)(ii), 219(g)(5)(A), (B).

110. *Id.* § 401(k)(11)(A)(ii), (C).

111. *Id.* §§ 401(k)(11)(A)(iii), 408(p)(3).

112. *Id.* § 401(k)(11)(D)(ii).

113. Treas. Reg. § 1.401-1(b)(1)(iii) (as amended in 1976).

114. *See generally* John E. Curtis et al., *Employee Stock Ownership Plans After 20 Years*, 22 TAX MGMT. COMP. PLAN. J. 382 (1994) (reflecting the author's views on the effect of ERISA after twenty years).

409(n) (if applicable) and, if the employer has a registration-type class of securities, section 409(e).[115]

An ESOP may be a separate plan, or a separate part of a plan.[116] An ESOP must be formally designated as such in the plan document,[117] and the plan must specifically state that it is designed to invest primarily in qualifying employer securities.[118]

5. *Money Purchase Pension Plan.* A money purchase pension plan is a plan under which the annual contribution to be made on behalf of each participating employee is specified in the plan. The required contribution is generally a percentage of salary: for instance, 5% of salary. Under some plans, the contribution rate varies by length of service, so that a higher percentage of salary is contributed for long-service employees. In some plans, the contribution is a level dollar amount for each employee, or a level dollar amount for each year of service completed by the employee.

As a pension plan, a money purchase plan (unlike a profit-sharing plan) is required to provide "definitely determinable" benefits:[119] the definiteness requirement is satisfied in a money purchase plan if the plan includes "a stipulated formula for computing . . . the contributions . . . so long as compliance with the formula is not within the discretion of the employer."[120]

It is important to note the difference between the contribution rate and the allocation rate. The fact that the plan requires the employer to contribute, each year, an amount equal to 5% of the total compensation of all eligible participants does not mean that each participant will be allocated 5% of his or her own compensation: a separate provision of the plan provides how the total contributions are allocated among the eligible participants. Provided that the plan has a definite allocation formula that complies with the applicable rules (for example, the nondiscrimination rule under Code section 401(a)(4) and

115. *See* I.R.C. § 4975(e)(7); ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6) (1996).

116. Treas. Reg. § 54.4975-11(a)(2) (as amended in 1979); 29 C.F.R. § 2550.407d-6(a)(4) (1977).

117. 29 C.F.R. § 2550.407d-6(a)(2).

118. 29 C.F.R. § 2550.407d-6(b).

119. Treas. Reg. § 1.401-1(b)(1)(i).

120. Gen. Couns. Mem. 35,745 (Mar. 22, 1974).

the Code section 415 limitations on contributions), the employer has considerable flexibility in deciding how to allocate contributions.

Under prior law, there were two other fundamental differences between profit-sharing and money purchase plans. First, forfeitures arising under a money purchase plan could not be reallocated to other participants; rather, they had to be used as soon as possible to reduce future employer contributions. This rule was repealed by the Tax Reform Act of 1986, so that money purchase forfeitures, like profit-sharing forfeitures, can now be reallocated or used to reduce future employer contributions, whichever the plan provides.[121] Second, the requirement that contributions to a profit-sharing plan be made out of the employer's current or accumulated profits was also repealed in 1986,[122] so an employer which has no profits can maintain either a profit-sharing plan or a money purchase plan.

If the plan is intended to be a money purchase plan, the plan must designate such intent at such time and in such manner as the Secretary may prescribe.[123]

6. *Target Benefit Plan.* A target benefit plan is a money purchase pension plan, which combines features of a defined benefit plan and a defined contribution plan. The plan establishes a target benefit to be funded by retirement age, such as a life annuity equal to 50% of the employee's final average salary. There is then calculated, for each participating employee, the level annual deposit which is required in order to accumulate the necessary fund by retirement age. That amount is then deposited into the employee's individual account, and the actual benefit payable at retirement or other termination of employment

121. I.R.C. § 401(a)(8); Treas. Reg. §§ 1.401-1(b)(1)(i), 1.401-7.

122. *See* I.R.C. § 401(a)(27)(A); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1136(a), 100 Stat. 2085, 2485 (1986) (amending I.R.C. § 401(a)(8)).

123. I.R.C. § 401(a)(27)(B). Money purchase plans are not subject to the "recurring and substantial" contributions requirement that the regulations impose on profit-sharing plans. Accordingly, some employers which have established qualified plans solely to receive rollovers or transfers from another plan have established money purchase pension plans with a contribution rate equal to 0% of compensation. The IRS has ruled that such a plan can qualify. *See* Memorandum, from Joyce E. Floyd, Chief, Employee Plans Technical Branch, National Office, to the District Director of the Los Angeles Key District (Sept. 10, 1995), *reprinted in* Finston & Gilles, 351-3rd T.M., Plan Qualification-Pension & Profit-Sharing Plans.

is the then vested balance of the account. Accordingly, the specified benefit is *only* a target and is *not* guaranteed or promised in any way: the actual benefit may be greater or less than the target benefit.[124]

7. *Key Differences Between Different Types of Qualified Defined Contribution Plans.* The differences between the different types of defined contribution plans will be discussed in greater detail below. Here, I summarize some key differences.

First, profit-sharing plans, 401(k) plans, stock bonus plans, and ESOPs are not subject to any minimum funding rules.[125] By contrast, money purchase pension plans (including target benefit plans) are subject to the minimum funding rules[126] and, if the required amount is not contributed, the employer must pay an excise tax,[127] unless it has obtained a funding waiver from the IRS.[128] This does not appear to be appropriate, based as it is on the pre-ERISA classification into pension plans and non-pension plans. Consider the following plan designs: (1) The plan provides that the employer will contribute 5% of compensation for each eligible participant. The plan states that it is a money purchase pension plan. (2) The plan provides that the employer will contribute 5% of compensation for each eligible participant. The plan states that it is a profit-sharing plan. (3) The plan provides that the employer will contribute 50% of elective deferrals for each eligible participant who made deferrals during the year. The plan states that it is a profit-sharing plan that includes a CODA.

In each case, the employer has made a contractual commitment to contribute to the plan, that commitment is not contingent upon profits and, if the employer fails to honor its commitment, the eligible participants can sue

124. Treas. Reg. §§ 1.401(a)(4)-8(b)(3) to 13(e). The prior rules for target benefit plans were set forth in Rev. Rul. 76-464, 1976-2 C.B. 65.

125. I.R.C. § 412(h)(1); ERISA § 301(a)(8), 29 U.S.C. § 1081 (2000); *see also infra* Part III.H. Note, however, that if a CODA is part of a pre-ERISA money purchase plan, or if an ESOP includes a money purchase plan, then the money purchase portion is subject to the minimum funding requirements.

126. I.R.C. § 412; ERISA §§ 301-308, 29 U.S.C. §§ 1081-1086 (1994 & Supp. III 1997).

127. I.R.C. § 4971.

128. *Id.* § 412(d); ERISA § 303, 29 U.S.C. § 1083 (1994).

under ERISA, or request the DOL to sue on their behalf, to enforce the plan provisions. In the first case, if the employer fails to contribute the amount specified, the employer has also violated the minimum funding requirements, and is liable for an excise tax equal to 10% of the shortfall.[129] The profit-sharing plan and 401(k) plan described in (2) and (3) above are not subject to the minimum funding standards, so an employer which fails to make the contributions described in the plan incurs no excise tax liability. I submit that there is no significant distinction between these three cases, and that the same (or no) minimum funding requirements should apply in each case.[130]

For historical reasons, there are additional differences between money purchase pension plans on the one hand and profit-sharing plans, stock bonus plans and ESOPs on the other. For instance, (1) money purchase plans are always subject to the qualified joint and survivor and qualified pre-retirement survivor annuity rules,[131] and (2) in-service distributions from a money purchase plan are generally prohibited, unless the participant has worked past normal retirement age or the plan has terminated.[132] Again, I argue below that the same annuity and distribution rules should apply to all defined contribution plans.[133]

Otherwise, the key difference between different defined contribution plan designs is the manner in which the employer contribution is allocated to, or divided between, the participants who are entitled to share in the contribution. The simplest approach is to allocate the contribution in proportion to the participant's compensation from the employer for the year in question. Thus, for instance, if the employer contributes $100,000 to its profit sharing plan for year 2000, and the total compensation for that year, of all participants entitled to share in the contribution, is $1 million, each participant will receive an

129. *See* I.R.C. § 4971(a).

130. For further discussion of this issue, see *infra* Part III.H.

131. I.R.C. §§ 401(a)(11), 417; ERISA § 205, 29 U.S.C. § 1055 (1994 & Supp. III 1997); *see also infra* Part VI.

132. *See* Rev. Rul. 69-277, 1969-1 C.B. 116 (pension plans); Rev. Rul. 60-323, 1960-2 C.B. 148 (modifying Rev. Rul. 56-693, 1956-2 C.B. 282 (profit-sharing plans)); *see also infra* Part IV and Appendix B.

133. *See infra* Part IV (distributions); *infra* Part VI (joint and survivor annuities).

allocation equal to 10% of his or her year 2000 compensation from the employer.

Sometimes, the allocation is coordinated, or "integrated," with the Social Security taxes paid by the employer. The theory underlying integration is that, as employer Social Security contributions are paid only on wages up to the Social Security taxable wage base ($80,400 for 2001), the higher paid employees should receive a larger contribution, as a percentage of pay, under the employer's plan, to compensate for the lower rate of contribution for them under Social Security. The use of integration was curtailed by the Tax Reform Act of 1986.[134]

Under a target benefit plan, the allocation will be based on age as well as compensation, so that older employees will receive a larger allocation, as a percentage of pay, than younger employees.[135] The motivation for this approach is typically that the key employees are, on the whole, older than the rank and file, so that they receive more under this method.

The most recent and, in many ways, most controversial approach is the so-called "new comparability" approach. For many years, it has been possible for an employer to aggregate two or more plans, for purposes of satisfying the employee coverage rules, if the plans provide "comparable" benefits.[136] "New comparability" refers to the current version of this technique, which is designed to comply with the regulations following the Tax Reform Act of 1986.[137]

A new comparability plan is a defined contribution plan, usually a profit-sharing plan. Under the new comparability approach, different groups of employees are identified in the plan, and each group receives a different

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134. *See* I.R.C. § 401(l); Treas. Reg. §§ 1.401(l)-1, 1.401(l)-6 (as amended in 1993). For criticism of the current rules, see *infra* Part III.J.

135. A target benefit plan that satisfies certain requirements qualifies for a safe harbor under the nondiscrimination regulations. *See* Treas. Reg. § 1.401(a)(4)-8(b)(3).

136. *See* Rev. Rul. 81-202, 1981-2 C.B. 93 (1981). An ESOP may not be considered together with another plan for purposes of satisfying section 401(a)(4) or (5) or 410(b) unless (1) the ESOP and the other plan existed on November 1, 1977 or (2) a special rule for combined ESOPs is satisfied. Treas. Reg. § 54.4975-11(e).

137. *See* Treas. Reg. §§ 1.401(a)(4)-8, 1.401(a)(4)-9, 1.410(b)-7.

allocation. The plan is designed to satisfy the Code's section 401(a)(4) nondiscrimination test on a benefits basis.[138]

The participating employees are grouped into two or more employee classes, for instance (1) officers (class 1) and other employees (class 2), or (2) partners (class 1), associates (class 2), and other employees (class 3). A separate contribution rate is then determined for each class: for instance, 20% of compensation for officers and 3% of compensation for other employees. In testing the plan for nondiscrimination, the contribution for each participant is then credited with interest for the period from the current year through normal retirement age. The accumulation is then converted into an actuarially equivalent annual benefit beginning at normal retirement age. The employer must then establish that those benefits are not discriminatory, i.e., that they do not represent a disproportionately higher percentage of compensation for highly compensated employees (HCEs) than for non-highly compensated employees (NHCEs). As the NHCEs tend to be younger than the HCEs, and so have a longer accumulation period, this can generally be achieved without much difficulty.

This technique is based upon, and was encouraged by, the IRS regulations under Code section 401(a)(4).[139] In 1994, the Clinton Administration proposed to prohibit defined contribution plans (other than target benefit plans) from cross-testing.[140] A Congressional committee cited members' concerns about "reports of significant abuses" in the use of cross-testing, but legislative attempts to restrict its use were unsuccessful.[141] The IRS has recently indicated

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138. *Id.* § 1.401(a)(4)-8. The cross-testing technique is not available for an ESOP or for the 401(k) or 401(m) portion of a plan. *See id.* § 1.401(a)(4)-8(b).

139. *Id.* § 1.401(a)(4)-8. In a 1991 legal memorandum, an IRS attorney concluded that the regulations under I.R.C. § 401(a)(4) could encourage schemes for making disparate allocations to HCEs under defined contribution plans. *See IRS Memo on Defined Contribution Plan Allocations to Highly Compensated Employees*, TAX NOTES TODAY, Oct. 17, 2000, *at* 2000 TNT 201-58; *see also* Vince Amoroso, *Building a Better Nondiscrimination Mousetrap*, 27 Pens. & Ben. Rep. (BNA) 2792, 2793 (Nov. 14, 2000) ("Some so-called age-weighted profit sharing plans provide benefits that are skewed much more in HCEs' favor than was imaginable under the pre-regulation rules.").

140. *See JCT Releases Description of H.R. 3396, The 'Retirement Protection Act'*, TAX NOTES TODAY, July 22, 1994, *at* 94 TNT 142-9.

141. *See House Committee Approves Pension Bill, with Changes by Reps. Gibbons, Johnson*, 21 Pens. & Ben. Rep. (BNA) 1451, 1451 (July 25, 1994) ("The

discomfort with the ways in which the technique is being used,[142] and recently proposed regulations imposing new requirements on new comparability plans.[143]

E. *Other Tax-Favored Defined Contribution Plans*

The following types of employer-sponsored defined contribution plans are not qualified plans, and thus are generally not required to comply with the qualification requirements listed in Code section 401(a) but, like qualified plans, receive tax-favored treatment. Each plan is subject to its own set of rules, and those rules sometimes make certain of the qualified plan rules applicable.

1. *Tax-Sheltered Annuity Plan.*[144] A tax-sheltered annuity program under Code section 403(b) may only be

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Committee believes that the Secretary of the Treasury should review its current nondiscrimination regulations in light of these abuses.").

142. *See* I.R.S. Notice 2000-14, 2000-1 C.B. 737.

143. *See* Prop. Treas. Reg. § 114697-00, 65 Fed. Reg. 59,774 (Oct. 6, 2000). A public hearing was held on January 25, 2001; Peter R. Orszag, CENTER FOR BUDGET AND POLICY PRIORITIES, HOW THE "CROSS-TESTING" LOOPHOLE HARMS LOW- AND MODERATE-INCOME WORKERS (2000), *available at* http://www.cbpp.org/3-2-00tax.htm (concluding that "[c]ross-tested plans carry significant negative ramifications for rank-and-file workers.... The Treasury Department's recent willingness to explore methods of curtailing the use of new comparability plans is a welcome development. But an even more aggressive policy stance, which would include the curtailment of cross-tested plans in addition to new comparability plans, may be warranted."); *Actuaries Seek Moratorium on Changes to Nondiscrimination Regs*, TAX NOTES TODAY, Mar. 30, 2000, *at* 2000 TNT 62-45 (American Society of Pension Actuaries (ASPA) comment letter to the IRS, stating that "[a]ny material changes to the nondiscrimination regulations relating to 'cross-testing' and 'new comparability' could result in the termination of small business retirement plans, thus denying small business employees a meaningful opportunity to save for retirement. Given the current lack of retirement plan coverage among small business employees, the last thing needed is any further reason for small businesses to not adopt a retirement plan or terminate their existing plans."); Colleen T. Congel, *Letters Reveal Split in Pension Industry over 'Comparability' Cross-Testing Methods*, 27 Pens. & Ben. Rep. (BNA) 1409 (June 13, 2000); Lee A. Sheppard, *New Comparability Plan Rules and Cross-Testing Generally*, TAX NOTES TODAY, Oct. 16, 2000, *at* 2000 TNT 200-9. An ASPA survey released in May 2000, found that new comparability plans have expanded small business retirement plan coverage and 50% of the small businesses surveyed said that they would not adopt another qualified plan if new comparability plans were no longer permitted. Cross-testing generally, and new comparability plans in particular, are discussed *infra* Part III.J.

maintained by: a charitable organization (as described in Code section 501(c)(3)); or a public educational organization (as described in Code section 170(b)(1)(A)(ii)), such as a state university.[145]

Contributions must generally be invested either in annuity contracts or in mutual fund shares.[146] However, church and church-related employers may invest in "retirement income accounts" which allow a broader range of investments.[147] As originally enacted in 1958, section 403(b) was designed primarily to limit the extent of tax deferral available to employees of tax-exempt organizations who voluntarily elected to reduce their salaries to pay premiums on annuity contracts.[148] Later, investment in mutual funds was permitted.[149] The pension rules of ERISA apply to those private sector 403(b) plans that are subject to ERISA, and the Tax Reform Act of 1986 extended many of the plan qualification requirements to 403(b) plans. Today, most private sector 403(b) plans perform precisely the same role as qualified plans, and there is no reason why they should not have access to the same broad range of investment choices.

Unless the employer is a church, the plan must satisfy the nondiscrimination requirements of section 403(b)(12).[150]

A section 403(b) plan may be either a defined contribution plan or a defined benefit plan; however, defined benefit section 403(b) plans are rare. Similarly, although it is possible for a section 403(b) plan to include a vesting schedule, most section 403(b) plans provide that all participants are 100% vested at all times.

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144. *See infra* Appendix C (describing the major characteristics of, and differences between, 403(b) plans and other plans that allow pre-tax employee deferrals).

145. *See* I.R.C. § 403(b)(1)(A).

146. *Id.* § 403(b)(1)(A), (b)(7).

147. A retirement income account is a defined contribution program established or maintained by a church, or by a convention or association of churches, including an organization described in I.R.C. § 414(e)(3)(A). *See id.* §§ 414(e)(3)(A), 403(b)(9).

148. *See* Technical Amendments Act of 1958, Pub. L. 85-866, Title I § 23(a), 72 Stat. 1606, 1620-22 (1958); H. Rep. No. 775, 85th Cong., 1st Sess., 1958-3 C.B. at 826.

149. *See* ERISA § 1022(b), 29 U.S.C. § 102(b) (1994).

150. I.R.C. § 403(b)(1)(D). The term "church" means a church as defined in I.R.C. § 414(e)(3)(A), including any qualified church-controlled organization, as defined in § 414(e)(3)(B).

Many section 403(b) plans are governmental or church plans and, as such, are exempt from ERISA.[151] Other section 403(b) plans *are* subject to ERISA, but the DOL regulations exempt certain plans which are funded exclusively by employee contributions, and where the employer has only a limited role with respect to the plan.[152] The exact scope of this regulatory exemption is unclear, and it is by no means obvious that the exemption is warranted. A 401(k) plan funded exclusively by employee contributions, and where the employer has only a limited role with respect to the plan, is subject to ERISA if it covers any common law employee: if ERISA protection is appropriate for the participants in this plan, why is it not appropriate for participants in an identical 403(b) plan? In practice, the effect of the exemption for 403(b) plans has often been to deter employers from sufficient involvement in the plan by, for instance, providing investment guidance, for fear of losing the exemption.[153]

The amount that can be contributed for an employee under a 403(b) plan, for any year, is subject to three separate limitations: First, elective employee deferrals are subject to a dollar limit, which is generally $10,500 for 2001. Employees who have completed at least fifteen years of service with a "qualified organization"[154] are allowed to contribute as much as $13,500.[155] Again, there is no apparent justification for this special rule. If it can be established that employees with at least fifteen years of service, or who have attained a certain age, need higher deferral limits, then the higher limits should apply to all types of plan and all types of employer. If, on the other hand, it can be established that employees of these "qualified organizations," and only employees of these organizations, need higher deferral limits, then the higher

151. ERISA § 4(b), 29 U.S.C. § 1003(b) (1994 & Supp. II 1996).

152. 29 C.F.R. § 2510.3-2(f) (as amended in 1982).

153. Ironically, tax-exempt employers would often be safer were their 403(b) plans subject to ERISA. In that case, suits under state law relating to the plan would generally be preempted by ERISA § 514, 29 U.S.C. § 1144 (1994 & Supp. IV 1998). The remedies available under ERISA are generally much more limited than those available under state law.

154. A "qualified organization" is an educational organization, hospital, home health service agency, health and welfare service agency, church, or convention or association of churches. *See* I.R.C. § 402(g)(8)(B).

155. *Id.* § 402(g)(1), (8).

limits should apply whether the employer has adopted a 403(b) plan or a 401(k) plan.

Second, the total amount contributed may not exceed the "exclusion allowance."[156] The exclusion allowance calculation is very complex because it depends not only on the employee's compensation, but also on the length of his or her service with the employer and contributions made in prior years to the employer's retirement plans (not just contributions made to the 403(b) plan). Also, the exclusion allowance applies only to 403(b) plans, and not to any other type of plan. When section 403(b) was enacted in 1958, Code section 415 (which limits contributions and benefits under qualified plans and 403(b) plans) had not yet been enacted, and the exclusion allowance was the method of limiting deferrals under 403(b) plans. With the enactment of section 415 in 1974, the exclusion allowance should have been repealed.

Finally, the total amount contributed may not exceed the limitation under Code section 415, which for 2001 is generally the lesser of $35,000 or 25% of the employee's compensation.[157] Certain employees may make special elections, which increase the amount permitted.[158] Again, there is no apparent justification for this special rule. If it can be established that employees of these organizations, and only employees of these organizations, need higher limits, then the higher limits should apply whether the employer has adopted a 403(b) plan or a 401(k) plan.

Finally, elective deferrals under a 403(b) plan, though they must generally be made available to all employees, with limited exceptions,[159] are not subject to any discrimination test similar to the ADP test for elective deferrals under a 401(k) plan. Again, why should a tax-exempt employer that sponsors a 403(b) plan be treated more favorably than a taxable employer, or a tax-exempt employer, that sponsors a 401(k) plan? Extension of the ADP test to 403(b) plans may significantly reduce the amount of deferrals available to faculty members of law schools and medical schools, and physicians and executives

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156. *See id.* § 403(b)(2).

157. *See id.* § 415(c).

158. *See id.* § 415(c)(4). Again, the favored employers are educational organizations, hospitals, home health service agencies, health and welfare service agencies, churches, and conventions or associations of churches. *Id.*

159. *See id.* § 403(b)(12)(A)(ii).

employed by hospitals, but this result is perfectly acceptable from a policy viewpoint.

There is an argument that this would prove burdensome for small tax-exempts, but it would be no more burdensome than the ADP test is for small businesses. And, in either case, the burden can be mitigated if the employer adopts a safe harbor plan or a SIMPLE plan. Under current law, a tax-exempt employer need concern itself with discrimination testing only if it has at least one employee who earned more than $85,000 during the preceding year.[160] While this is hardly wealth beyond the dreams of avarice, it is difficult to argue that a tax-exempt organization which can afford a salary at this level is entitled to more solicitude than a small business, given that many small business owners earn substantially less than this amount.

2. *Simplified Employee Pension Plan.*[161] A SEP is a type of IRA, subject to the rules of Code section 408(k), rather than a qualified plan subject to the rules of Code section 401. SEPs were introduced in 1978[162] and were intended as a simpler retirement vehicle for small employers, though the statute does not limit them to small employers. The use of SEPs has been inhibited by three major disadvantages. First, most small employers are not aware that they exist.[163] Second, the SEP rules are not, in fact, much simpler than the rules for qualified plans, and in several key respects they are significantly more restrictive than the qualified plan rules.[164] Third, SEPs are generally set up for small employers by financial institutions, whose sales personnel rarely have sufficient expertise to advise the employer fully on the pros and cons of different types of plan, and pension experts are rarely involved in the design or administration of the SEP. Accordingly, noncompliance

160. I.R.C. § 414(q).

161. *See infra* Appendix A (comparing SEPS and qualified profit-sharing plans).

162. *See* Revenue Act of 1978, Pub. L. 95-600, § 152(b), 92 Stat. 2765, 2797 (1978).

163. In both 1990 and 1996, the Bureau of Labor Statistics found that only about 1% of full-time employees in small (100 or fewer employees) private establishments participated in a SEP. *See CRS Report*, *supra* note 11; *see also* SERS, *supra* note 19.

164. Under I.R.C. § 408(c), added by ERISA, an employer could establish an IRA plan for its employees, or an employee association could establish an IRA plan for its members. Such plans are rare.

with the SEP requirements is the rule rather than the exception.

All SEPs are defined contribution plans. Some plans (usually collectively bargained plans) specify a fixed contribution rate. Most plans function like qualified profit-sharing plans, in that the annual contributions are discretionary. The employee's share of the employer contribution, and any employee contributions, are allocated to the employee's own IRA, which he or she controls.

Any SEP account balance is always fully (100%) vested.[165] SEPs are subject to the same restrictions, on the operation and investment of funds, as IRAs.[166]

The law also provides for salary reduction SEPs (SARSEPs), to which employees may make elective, pre-tax contributions.[167] A SARSEP may not be maintained by an employer with more than twenty-five employees who were eligible to participate, or who would have been required to be eligible if a SEP were maintained, at any time during the preceding year.[168] A SARSEP may not be maintained by a state or local government or political subdivision thereof, or by an agency or instrumentality thereof, or by a tax-exempt organization.[169] No new SARSEP may be adopted after December 31, 1996.[170]

3. *SIMPLE Plan.*[171] SIMPLE plans were introduced by the Small Business Job Protection Act in 1996. The law provides for both SIMPLE IRAs[172] and SIMPLE 401(k) plans;[173] the latter offer few advantages and are rare. A SIMPLE plan is available only to an employer which, for the preceding year, had no more than 100 employees who earned at least $5000 from the employer.[174] However, there

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165. *See* I.R.C. § 408(a)(4).

166. No SEP funds may be invested in life insurance. *Id.* § 408(a)(3).

167. *Id.* § 408(k)(6).

168. *Id.* § 408(k)(6)(B).

169. *Id.* § 408(k)(6)(E).

170. *Id.* § 408(k)(6)(H).

171. *See infra* Appendix C (describing the major characteristics of SIMPLE plans and other plans that allow pre-tax deferrals by employees).

172. *See* I.R.C. § 408(p).

173. *Id.* § 401(k)(11); *see also supra* Part II.D.2.b.

174. *See* I.R.C. § 408(p)(2)(C)(i). The employer aggregation rules of section 414 apply in determining whether the employer satisfies this requirement.

is a grace period for previously eligible employers that exceed this limit.[175]

Under a SIMPLE IRA, the employee's contributions, and the employee's share of the employer contribution, are allocated to the employee's own IRA, which he or she controls.

Any SIMPLE account balance is always fully (100%) vested.[176] SIMPLE IRAs are subject to the same restrictions, on the operation and investment of funds, as other IRAs.

As yet, it is too early to determine whether SIMPLE plans are a success.[177] There are at least two major potential drawbacks. First, the rules for SIMPLE plans are not really that much simpler than, and in several key respects they are significantly more restrictive than, the qualified plan rules. Second, like SEPs, SIMPLE plans are generally set up for small employers by financial institutions, whose sales personnel rarely have sufficient expertise to advise the employer fully on the pros and cons of different types of plans, and pension experts are rarely involved in the design or administration plan. Accordingly, it is almost inevitable that noncompliance with the SIMPLE requirements will be the rule rather than the exception.

4. *Eligible Deferred Compensation Plan.*[178] An eligible deferred compensation plan under Code section 457[179] may be sponsored by a governmental employer or by a private tax-exempt employer (other than a church). In the case of a private tax-exempt employer, the plan's coverage must be limited to a "select group" of management or highly compensated employees, in order to avoid problems under ERISA.[180] In the case of a governmental employer, the plan may (and generally does) cover employees in general.

A 457 plan can be funded with employer contributions and/or employee contributions. Employee contributions are generally made on a pre-tax, payroll deduction basis, like

175. I.R.C. § 408(p)(2)(C)(ii), (p)(10).

176. *Id.* § 408(a)(4).

177. *See* SERS, *supra* note 19; *supra* text accompanying note 25.

178. *See infra* Appendix C (describing the major characteristics of 457 plans and other plans that allow pre-tax deferrals by employees).

179. The requirements for an eligible plan are set out in I.R.C. § 457(b). The tax treatment of an ineligible plan is described in I.R.C. § 457(f).

180. *See* ERISA §§ 201(2), 301(a)(3), 401(a)(1), 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (1994).

elective deferrals under a 401(k) plan. The importance of 457 plans for government employees is that they are often the only available vehicle for an employee who wants to make voluntary, tax-deferred retirement plan contributions through the employer. Most governmental employers are not allowed to sponsor 401(k) plans, and the only public sector employers that can sponsor a 403(b) (tax-sheltered annuity) arrangement are educational institutions.

If the plan satisfies the requirements of Code section 457(b), then taxation of the amounts deferred (and investment earnings thereon) is generally deferred until the employee begins to receive benefits under the plan.[181]

The maximum annual deferral (employer contributions plus employee contributions) for 2001 is the lesser of $8500 or 25% of the employee's compensation from the employer, subject to a catch-up rule for participants close to normal retirement age.[182] The maximum is reduced by the amount deferred in that year under certain other retirement plans.[183]

III. KEY AREAS WHERE THE RULES DIFFER FOR DIFFERENT TYPES OF DEFINED CONTRIBUTION PLANS

A. *Employee Eligibility and Coverage*[184]

1. *Qualified Plan and 403(b) Eligibility Rules.* A qualified plan may not require, as a condition of participation, that an employee attain a minimum age greater than twenty-one, and may not impose a maximum age. Also, a qualified plan may not impose a minimum service requirement exceeding one year of service, unless

181. I.R.C. § 457(a). Under current law, § 457 plan benefits cannot be rolled over tax-free to an IRA.

182. *Id.* § 457(b)(2)-(3), 457(e)(15).

183. *Id.* § 457(c).

184. The rules of I.R.C. § 410 and ERISA § 202 do not apply to a governmental plan or, unless it makes an election under § 410(d), to a church plan. *Id.* § 410(c)(1); ERISA § 4(b)(2), 29 U.S.C. § 1003(b)(2) (1994 & Supp. II 1996). A qualified church plan must satisfy the coverage rules that were in effect under I.R.C. § 401(a)(3) immediately prior to the enactment of ERISA. *See* I.R.C. § 410(c)(2).

the plan provides full and immediate vesting, in which event two years of service can be required.[185]

With respect to elective deferrals by employees under a CODA that is part of a 401(k) plan, the plan may not require completion of more than one year of service.[186] By contrast, under a section 403(b) plan maintained by any employer other than a church, all employees must be able to elect to defer more than $200 per year, if any employee has that right.[187] In applying this test, the employer may not impose any waiting period, but the 403(b) plan may exclude: (1) any employee who is a participant in an eligible deferred compensation plan under section 457; (2) any employee who is a participant in a 401(k) plan; (3) any employee who is a participant in another 403(b) plan; (4) any nonresident alien described in section 410(b)(3)(C); and (5) subject to certain conditions, a student performing certain services for a school, college or university, and employees who normally work less than twenty hours per week.[188]

These rules should be harmonized, as there is no good reason for having different rules for 401(k) plans and 403(b) plans.

In addition, given the significant changes in work patterns since ERISA was enacted in 1974, the basic coverage rules should be reviewed. The ERISA rules represented a significant change from pre-ERISA law, under which a five year service requirement and a minimum age of thirty were generally permissible. The ERISA rules have already been tightened twice, first when the minimum age was reduced from twenty-five to twenty-

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185. I.R.C. § 410(a)(1); ERISA § 202(a)(1), 29 U.S.C. § 1052(a)(1) (1994). The term "year of service" is defined in I.R.C. § 410(a)(3) and ERISA § 202(a)(3), 29 U.S.C. § 1052(a)(3), and generally requires completion of at least 1000 "hours of service" (essentially, all working and non-working hours for which an employee is paid) during the applicable twelve month computation period. Alternatively, service can be determined on an elapsed time basis. The minimum age can be up to age twenty-six for a plan maintained exclusively for employees of a tax-exempt educational institution, as defined in I.R.C. § 170(b)(1)(A)(ii), if each participant with at least one year of service is fully vested in the accrued benefit as it accrues. I.R.C. § 410(a)(1)(B)(ii); ERISA § 202(a)(1)(B)(ii), 29 U.S.C. § 1052(a)(1)(B)(ii).

186. I.R.C. § 401(k)(2)(D).

187. *Id.* § 403(b)(12)(ii).

188. *Id.* § 403(b)(12).

one in 1984,[189] and secondly when the ability to impose a maximum age, previously available for defined benefit and target benefit pension plans, was abolished in 1986.[190]

The one year of service requirement appears to be based on the no longer valid premise that the typical employee will have two or three jobs during his or her working life. The average job tenure is now less than five years and, for an employee who has a series of jobs, each of five years or less, the cumulative effect of being subjected to a one year waiting period by each employer can drastically reduce the ultimate retirement benefit. The Code has already been amended to encourage employers to allow earlier 401(k) plan participation,[191] and an increasing number of employers, motivated primarily by the tight labor market, are allowing new employees to make deferrals immediately after being hired.[192] According to a recent survey, 52% of the 401(k) plans allow employee deferrals within the first three months after the employee is hired, up from 32% in 1998. 37% of 401(k) plans allow deferrals during the first month of employment, up from 24% in 1998.[193]

A radical change to the present rules would be to prohibit any waiting period for any type of plan. Less radical alternatives would be (1) to give employers incentives to encourage reducing or eliminating waiting periods or (2) to require that employees be allowed to start making 401(k) deferrals either immediately after they are hired or within a short period (such as three months) thereafter.

Another drawback of the present rules is that they permit the permanent exclusion of part-time employees.[194] If the plan requires one year of service for eligibility, and defines a year of service to mean completion of 1000 hours

189. Retirement Equity Act of 1984, Pub. L. 98-397, § 202, 98 Stat. 1436 (codified as amended at 26 U.S.C. § 410 (1994)).

190. Omnibus Budget Reconciliation Act of 1986, Pub. L. 99-509, § 9201, 100 Stat. 1973-74 (codified as amended at 29 U.S.C. § 623 (1994)).

191. I.R.C. §§ 401(k)(3)(F), 410(b)(4).

192. *See* Pub. L. No. 106-361, 114 Stat. 1400 (codified as amended in scattered sections of 5 U.S.C. (1994)); *see also* Louis C. LaBrecque, *Congress Passes Bill to Allow New Hires to Begin Immediate Savings Participation*, BNA PENSION & BENEFITS DAILY, Oct. 16, 2000.

193. PROFIT-SHARING/401(K) COUNCIL OF AMERICA, 401(K) AND PROFIT SHARING PLAN ELIGIBILITY SURVEY 2000 (2000), *available at* http://www.psca.org.

194. *See supra* note 11 and accompanying text (concerning the level of coverage of part-time employees).

of service during a twelve month eligibility computation period, then an employee who has 900 hours of service each year for twenty years will never become a plan participant. Even if the employee does reach the 1000 hour threshold in at least one year, and thus becomes a participant, he or she may never become vested if the plan also requires 1000 hours of service to be credited with a year of service for vesting purposes.

2. *SEP and SIMPLE Eligibility Rules.* As might be expected, the coverage rules for SEPs and SIMPLE plans, designed for smaller employers, differ from the qualified plan rules. They also, for no good reason, differ from each other. A SEP is generally required to cover any employee who has attained age twenty-one, has performed some service (no matter how little) for the employer during at least three of the immediately preceding five years, and earns at least $300 (indexed, the 2001 threshold is $450) from the employer for the current year.[195] A SIMPLE plan is generally required to be available to every employee who has earned at least $5000 from the employer in any two prior years, and is reasonably expected to earn at least $5000 during the current year.[196]

If both SEPS and SIMPLE plans are to be retained, then the eligibility rules should be harmonized. The SEP and SIMPLE rules are better than the qualified plan rules to the extent that they require coverage of many, if not most, part-time employees. However, I suggest that, in view of the considerations discussed above, the present service requirements are too long.

3. *Employee Coverage.* Subject to limited exceptions, the most important of which allows the exclusion of collectively bargained employees for whom retirement benefits were the subject of good faith bargaining, a SEP or SIMPLE plan is required to cover all employees who have satisfied the above requirements.[197] The rule for qualified plans and 403(b) plans is less stringent.

195. I.R.C. § 408(k)(2), (8).

196. *Id.* § 408(p)(4). The $5000 figure is not indexed for cost of living increases.

197. *Id.* § 408(k)(2), (k)(8), (p)(4).

First, the employer must determine which employees are included in the coverage base. Employees of certain related employers must generally be included,[198] even if those employers do not sponsor the plan, as must employees who terminated employment during the year with more than 500 hours of service.[199] Employees who are excluded under one of the statutory exclusions (minimum age, minimum service, collectively bargained employees described above) can be excluded, along with employees who terminated employment during the year with 500 or fewer hours of service.[200]

Second, the employer must determine which of the employees taken into account are highly compensated employees (HCEs). Essentially, a HCE is any person who (1) earned at least $80,000 (indexed) from the employer during the preceding year (and, if the employer so elects, was among the highest paid 20% of employees) or (2) owned, directly or by attribution (for instance, from a family member), more than 5% of the employer at any time during the current or preceding year.[201] Any plan participant who is not a HCE is a non-highly compensated employee (NHCE).

Third, the employer must determine which participants actually benefit under the plan for the year. Generally, "benefiting" requires that a contribution is allocated to the employee's account for that year.[202] However, there are exceptions, the most important of which provides that a participant in a 401(k) plan will be treated as benefiting if he or she was eligible to make a deferral, even if none was actually made.[203]

Fourth, the employer must establish that, for the year being tested, the plan satisfies any one of three mathematical tests:[204] (1) the plan benefits at least 70% of the non-excludable NHCEs;[205] (2) the plan benefits a

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198. *Id.* § 414(b), (c), (m). Employees of "separate lines of business" may be tested separately. *Id.* § 414(r). However, few employers can satisfy the requirements of the regulations. *See* Treas. Reg. § 1.414(r)-1, 1.414(r)-11 (as amended in 1994); *see also* David A. Pratt & Charles Lockwood, *IRS Finalizes Separate Line of Business Rules*, 21 J. PENSION PLAN. & COMPLIANCE 66 (1995).

199. Treas. Reg. § 1.410(b)-6(f)(v).

200. *Id.* § 1.410(b)-6(f)(v).

201. I.R.C. § 414(q).

202. Treas. Reg. § 1.410(b)-3.

203. *Id.* § 1.410(b)-3(a)(2)(i).

204. I.R.C. § 410(b).

205. *Id.* § 410(b)(1)(A); Treas. Reg. § 1.410(b)-2.

percentage of the non-excludable NHCEs that is at least 70% of the percentage of non-excludable HCEs benefiting under the plan[206] (thus, under this test, if the plan benefits 100% of the HCEs, it must benefit at least 70% of the NHCEs; if the plan benefits only 80% of the HCEs, it need only benefit 56% of the NHCEs); and (3) the plan satisfies the requirements that it benefits a classification of employees that is found by the Secretary not to discriminate in favor of HCEs, and that the average benefit percentage for non-excludable NHCEs is at least 70% of the average benefit percentage for non-excludable HCEs.[207]

It is apparent that, even under the first test, the employer can provide no benefits for up to 30% of its non-excludable NHCEs, even though they have satisfied the plan's age and service eligibility requirements.[208] Under the other two tests, the employer can often pass the test by covering significantly less than 70% of those NHCEs. And compliance is made easier by two other rules. First, subject to limited exceptions, the employer can aggregate two or more plans for purposes of coverage testing, so that an employer can have separate plans for separate corporations, locations or divisions.[209] Second, a single plan that provides different levels of contributions or benefits to different groups of employees can be divided into separate "rate groups" for testing purposes.[210]

The 70% threshold has a long history:[211] however, even conceding that the 100% coverage rule that applies to SEPs and SIMPLE plans may be unduly restrictive for larger employers, 70% is simply too low. I suggest that the 70% threshold be increased gradually to 90%. This would have a significant effect beyond the coverage area. As discussed in Part III.J below, the non-discrimination rules for qualified plans are intertwined with the coverage rules so that, if the coverage rules are tightened, the permissible disparity

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206. I.R.C. § 410(b)(1)(B); Treas. Reg. § 1.410(b)-2.

207. I.R.C. § 410(b)(2); Treas. Reg. §§ 1.410(b)-4, 1.410(b)-5.

208. This assumes that their exclusion does not violate any employment discrimination legislation.

209. I.R.C. § 410(b)(6)(B); Treas. Reg. § 1.410(b)-7.

210. Treas. Reg. § 1.401(a)(4)-2(c), 1.401(a)(4)-3(c).

211. *See, e.g.*, Internal Revenue Code of 1939, Pub. L. No. 76-1, § 165, 53 Stat. 67 (amended by the Revenue Act of 1942, Pub L. No. 77-753, § 162, 56 Stat. 798, 862-63).

between the rate of contributions for HCEs and the rate for NHCEs would also be significantly reduced.

B. *Allocation of Contributions*

1. *In General.* The traditional rule for qualified plans is that an allocation need not be made to the account of every employee who participated in the plan during the year. So, for instance, many plans provide that, in order to receive an allocation, the employee must have at least 1000 hours of service during the year and/or still be employed by the employer at the end of the year.[212]

A profit-sharing plan must provide a definite predetermined formula for allocating contributions among the plan participants.[213]

Under a SEP, contributions are required for every employee who has satisfied the statutory eligibility requirements described in Part III.A.2 above. The SEP must have a definite written allocation formula which specifies the requirements that the employee must satisfy to share in an allocation, and the manner in which the amount allocated is computed.[214]

2. *Special Rules.* There are certain situations where allocations are required to be made to the accounts of certain employees.

First, if the employer decides to make matching contributions then, under a safe harbor 401(k) plan, the employer must provide matching contributions that equal or exceed 100% of each NHCE's elective deferrals up to 3% of compensation, plus 50% of the elective deferrals between

212. *See, e.g.*, Rev. Rul. 76-250, 1976-2 C.B. 124. Note that these provisions can lead to problems for a small plan under the current coverage and nondiscrimination regulations, as an employee who participated in the plan is generally required to be taken into account, for purposes of those rules, unless he or she terminated employment with fewer than 501 hours of service during the year. Treas. Reg. § 1.401(b)-6(f)(v).

213. Treas. Reg. § 1.401-1(b)(1)(ii). Although not specifically required by the regulations, in practice any type of qualified defined contribution plan must specify how contributions are allocated to individual participants' accounts.

214. I.R.C. § 408(k)(5). Almost all SEPs use a standard IRS form (Form 5305-SEP or 5305A-SEP), which provides for contributions to be allocated to each participating employee, in proportion to compensation for the year.

3% and 5% of compensation.[215] For this purpose, the Code section 414(s) definition of compensation is used, the match can be based on compensation earned after the participant entered the plan,[216] rather than compensation for the entire year, and the match can be calculated on a monthly or quarterly basis.[217] The contribution must be made for a NHCE who terminates employment during the year.[218]

Under a SIMPLE plan, the employer must provide matching contributions that equal 100% of each eligible employee's deferrals up to 3% of compensation.[219] For this purpose, the Code section 6051(a)(3) and (8) definition of compensation is used,[220] the match must be based on compensation for the entire year,[221] and the match cannot be calculated on a monthly or quarterly basis. The contribution must be made for an employee who terminates employment during the year.[222]

Second, if the employer decides to make nonelective contributions then, under a safe harbor 401(k) plan, the employer must make a nonelective contribution equal to 3% of each NHCE's compensation.[223] For this purpose, the Code section 414(s) definition of compensation is used, and the contribution can be based on compensation earned after the participant entered the plan.[224] The contribution must be made for a NHCE who terminates employment during the year.[225]

Under a SIMPLE plan, the employer must make a nonelective contribution equal to 2% of each eligible

215. *Id.* § 401(k)(12)(B).

216. *Id.* § 401(k)(9); I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

217. I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

218. I.R.C. § 401(k)(12)(B).

219. *Id.* § 408(p)(2)(A)(iii). Under a SIMPLE IRA, the employer may elect to apply a lower percentage (not less than 1% of compensation) for up to two years in any five year period. *Id.* § 408(p)(2)(C)(ii)(II).

220. *Id.* §§ 401(k)(11)(D)(i), 408(p)(6)(A)(i). For a self-employed individual, compensation means net earnings from self-employment, determined without regard to any SIMPLE contribution. *Id.* § 408(p)(6)(A)(ii).

221. *Id.* §§ 408(p)(2)(A)(iii), 401(k)(11)(D)(i).

222. *Id.* § 408(p)(2)(A)(iii). Note that, under a SIMPLE IRA that provides for matching contributions, the Code section 401(a)(17) compensation limitation does not apply. The limitation does apply to a SIMPLE IRA that provides for nonelective contributions, and also to a SIMPLE 401(k) plan. *Id.* §§ 401(a)(17), 408(p)(2)(B)(ii). There is no good reason for this difference.

223. I.R.C. § 401(k)(12)(C).

224. I.R.S. Notice 2000-3, 2000-4 I.R.B. 413.

225. I.R.C. § 401(k)(12)(C).

employee's compensation, but only if the employee has at least $5000 of compensation from the employer for the year.[226] For this purpose, the Code section 6051(a)(3) and (8) definition of compensation is used, and the contribution must be based on compensation for the entire year.[227] The contribution must be made for an employee who terminates employment during the year.[228]

Third, if the plan is "top-heavy" for the plan year, the employer must make a nonelective contribution equal to a percentage of each non-key employee's compensation.[229] The percentage is the lesser of 3% or the highest rate of employer contribution (including elective deferrals) for any key employee for that plan year.[230] For this purpose, the Code section 415(c)(3) definition of compensation is used, and the contribution must be based on compensation for the entire year. Unlike the other required allocations described above, the contribution need not be made for an individual who terminates employment during the year[231] and the contribution need not be fully vested when made.[232]

C. *Top-Heavy Plans*

When the top-heavy plan rules[233] were enacted by the Tax Equity and Fiscal Responsibility Act of 1982, they imposed on top-heavy plans (essentially, those plans or groups of plans in which more than 60% of the total accrued

226. *Id.* §§ 401(k)(11)(B)(ii), 408(p)(2)((B)(i).

227. *Id.* §§ 401(k)(11)(D)(i), 408(p)(6)(A)(i). The compensation taken into account is subject to the limitation of § 401(a)(17) ($170,000 for 2000). *Id.* §§ 401(a)(17), 408(p)(2)(B)(ii).

228. *Id.* §§ 401(k)(11)(B)(ii), 408(p)(2)(B)(i).

229. Note that the group of employees who must receive the minimum contributions are the "non-key employees," not the NHCEs. While these groups overlap considerably, they are not identical. *See infra* note 242.

230. I.R.C. § 416(c)(2).

231. Treas. Reg. § 1.416-1 (as amended in 1991).

232. *Id.* § 1.416-1. There is one situation where allocations to a group of participants are prohibited. If an ESOP acquires employer securities, in a transaction to which I.R.C. § 1042 applies (non-recognition of capital gain by the seller), then § 409(n) prohibits the allocation of those securities to the accounts of certain plan participants. An excise tax is imposed on any prohibited allocation. I.R.C. § 4979A.

233. Tax Equity and Fiscal Responsibility Act of 1982 § 240(c), Pub. L. No. 97-248, 96 Stat. 514 (codified as amended at 26 U.S.C. § 416 (1994)).

benefits is attributable to "key employees")[234] requirements that were considerably more stringent than those applicable to other qualified plans. However, as a result of subsequent legislation, the rules for top-heavy defined contribution plans now differ from those for other plans in only two respects. First, top-heavy plans must provide faster vesting (three year cliff vesting or six year graded vesting, as compared to five year cliff vesting or seven year graded vesting).[235] Second, a top-heavy defined contribution plan is required to provide, for each non-key employee, the minimum contribution described above.[236]

A recent General Accounting Office report concluded that these top-heavy rules do still benefit non-key employees.[237] Accordingly, rather than repealing the top-heavy rules, as many small business advocates have urged, it appears to be more appropriate to attempt to reduce the additional burdens that they create for small businesses. I suggest the following changes.

First, modify the definition of the top-heavy minimum contribution by (1) making it identical to the nonelective contribution under a safe harbor 401(k) plan, (2) repealing the rule that elective deferrals are included in calculating the highest contribution rate for any key employee,[238] and (3) repealing the rule that matching contributions may not be used to satisfy the top-heavy minimum.[239]

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234. The term "key employee" is defined in I.R.C. § 416(i)(1) and, subject to complex special rules, includes any person who is, or has been at any time during the four preceding plan years, (1) a 5% owner, (2) a 1% owner whose annual compensation from the employer is more than $150,000, (3) an officer of the employer whose compensation for the plan year exceeds 50% of the defined benefit dollar limit (currently $140,000) under I.R.C. § 415 and (4) one of the ten employees who both own (actually or constructively) the largest interests in the employer and have annual compensation greater than the defined contribution dollar limit (currently $35,000) under I.R.C. § 415. Any participant who is not a key employee is a "non-key employee." I.R.C. § 416(i)(2).

235. *Id.* §§ 416(b), 411(a)(2).

236. *Id.* § 416(c). The top-heavy plan requirements apply to qualified plans, 403(a) plans and SEPs. *See id.* §§ 401(a)(10)(B), 403(b), 408(k)(1)(B), 416; Treas. Reg. § 1.416-1. They do not apply to 403(b) plans, SIMPLE 401(k) plans, or SIMPLE IRAs. *See* I.R.C. §§ 401(k)(11)(D)(ii), 416(g)(4)(G).

237. GEN. ACCT. OFF., PRIVATE PENSIONS: "TOP-HEAVY" RULES FOR OWNER-DOMINATED PLANS (2000); *see also* Lee A. Sheppard, *Grassley and GAO Dustup About Merits of Top-Heavy Rules*, 89 TAX NOTES 182, 182 (2000).

238. Treas. Reg. § 1.416-1.

239. *Id.*

Second, the terms "key employee" and "non-key employee"[240] have very little applicability outside section 416. They overlap significantly with, but are not identical to, the definitions of HCE and NHCE, which are used to test for non-discrimination throughout the Code's retirement plan provisions.[241] Considerable simplification would result from replacing references to key employees and non-key employees with references to HCEs and NHCEs.[242]

Third, under current law, the methodology for determining whether a plan is top-heavy is unnecessarily complex. As it is based on the value of accumulated benefits, whether a plan is top-heavy could depend, in a plan that allows participant investment direction, on how successful the key employees' investment choices are, by comparison to those of the non-key employees. Under current law, in the case of a SEP, top-heaviness can be tested on the basis of aggregate employer contributions,

240. I.R.C. § 416(i)(1), (2).

241. The HCE classification is broader than the key employee group to the extent that it includes a person who earned more than $85,000 (indexed) in compensation from the employer in the prior year, even though that person is neither an owner nor an officer. However, the key employee group is generally larger than the HCE group, as it includes the following NHCEs: (1) a person who was not a 5% owner at any time during the current or preceding plan year, but was a 5% owner at any time during the three prior years, (2) a 1% owner who is not a 5% owner, and whose annual compensation from the employer is more than $150,000, (3) an officer of the employer who is not a 5% owner and whose compensation for the plan year exceeds 50% of the defined benefit dollar limit (currently $140,000) under I.R.C. § 415 but whose compensation for the prior plan year did not exceed $85,000 (indexed) and (4) one of the ten employees who own (actually or constructively) the largest interests in the employer, have annual compensation greater than the defined contribution dollar limit (currently $35,000) under section 415, and are not 5% owners and did not earn more than $85,000 (indexed) in compensation from the employer for the prior year. If the employer makes the "top-paid group" election in determining its HCEs, then this will increase the number of people who are key employees but not HCEs. *See* I.R.C. § 414(q) (defining "highly compensated employee"); I.R.C. § 416(i)(1) (defining "key employee").

242. Section 403(b) plans are not subject to the top-heavy rules. Given the definition of "key employee", and the types of employers that are allowed to sponsor 403(b) plans, there would be few conceivable situations in which a 403(b) plan would be top-heavy. However, were top-heaviness to be determined by reference to HCEs rather than key employees, then the top-heavy rules should be extended to private sector 403(b) plans. *See id.* § 416(g) (defining "top-heavy" retirement plans).

rather than account balances.[243] This rule should be extended to qualified plans.

D. *Limits on Contributions*

1. *Elective Deferrals.* Employees may make elective, pre-tax deferrals under several types of plan.[244] The limits applicable to each type of plan are different, and this causes considerable complexity.

a. *Dollar Limits.* The dollar limits apply at the level of the individual participant so if, during a particular calendar year, the participant is covered by two or more deferral arrangements, the limits are applied to the cumulative deferrals under all such arrangements, even if the arrangements are sponsored by unrelated employers.[245]

The dollar limits are all adjusted periodically for cost of living increases. For 2001, the dollar limit is generally $10,500. However, a higher limit (up to $13,500) applies in the case of 403(b) contributions for a "qualified employee" of a "qualified organization".[246] Lower limits apply to SIMPLE plans ($6500) and section 457(b) plans ($8500).[247]

The lower limits for SIMPLE plans and 457 plans can be justified on the basis that there are no nondiscrimination rules applicable to those plans. However, the dollar limit for 403(b) plans and 401(k) plans should be the same, and the special rules allowing larger deferrals by certain 403(b) plan participants should be repealed.

b. *Other Limits.* Elective deferrals under a 401(k) plan must satisfy the actual deferral percentage (ADP) test.[248] If

243. *See id.* § 416(i)(6).

244. This includes a trust described in I.R.C. § 501(c)(18). I have never encountered one of these in practice and, as one of the criteria is that the trust must have been established before June 5, 1959, I assume that they are few in number. In any event, they are not discussed in this article. For a description of the major characteristics of the different types of plan that allow elective, pre-tax deferrals by employees, see *infra* Appendix C.

245. I.R.C. § 402(g)(1), (3).

246. *Id.* § 402(g)(8), (5).

247. Under I.R.C. § 457, the deferral may be as much as $15,000 in any one or more of the individual's last three taxable years before he or she attains normal retirement age under the plan. *Id.* § 457(b)(3).

248. *Id.* § 401(k)(3); *see also supra* Part II.D.2.

the plan satisfies the requirements for a SIMPLE 401(k) plan or a safe harbor 401(k) plan, the ADP test is deemed to be satisfied.[249]

Elective deferrals under a non-church 403(b) plan must generally be available to all employees,[250] and must not exceed the maximum exclusion allowance described below, but are not subject to a test comparable to the ADP test.

Elective deferrals under a 401(k) plan may not exceed 25% of the employee's compensation (including the deferral) for the year.[251] The same limit also generally applies to elective deferrals under a 403(b) plan but, if the maximum deferrals have been made under a 403(b) plan from the outset, the MEA may limit the deferral to a lesser amount.

2. *The Maximum Exclusion Allowance.* The maximum exclusion allowance (MEA) applies only to 403(b) plans. For any year, the MEA for an individual is equal to 20% of the employee's "includible compensation," multiplied by the number of "years of service," minus the aggregate amount contributed by the employer and excludible from the employee's gross income for all prior years.[252]

Alternatively, an employee of certain types of organization[253] may irrevocably make the "C" election, in which case the MEA is the amount which could be contributed under Code section 415, without regard to section 415(c)(8), to a defined contribution plan (generally, for 2001, the lesser of $35,000 or 25% of compensation).[254]

The major difficulty in performing the MEA calculation is that it requires the use of accurate data for the entire period of the employee's service with the employer. In addition, the terms used in the calculation are defined differently than similar terms used elsewhere in the Code's pension rules, and the MEA definitions are unnecessarily complex.

First, "includible compensation" means compensation received from the employer that is includible in gross income (determined without regard to section 911),

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249. *See* I.R.C. § 401(k)(11), (k)(12)(A), (m)(10), (m)(11).

250. *Id.* § 403(b)(1)(D), (b)(12)(A)(ii).

251. *Id.* § 415(c)(1)(B), (c)(3)(A).

252. I.R.C. § 403(b)(2)(A); Treas. Reg. § 1.403(b)-1(d) (as amended in 1986).

253. I.R.C. § 415(c)(4)(C).

254. *Id.* §§ 403(b)(2)(B), 415(c)(1). Special rules apply to ministers and lay employees of a church. *Id.* § 403(b)(2)(C), (D).

including any elective deferral and any elective contribution or deferral under a cafeteria plan or 457 plan. Compensation is determined for the most recent period of service, ending no later than the close of the taxable year in question, that may be counted as a year of service under section 403(b)(4); this is not necessarily the most recent year.[255]

The MEA calculation is so complicated that it is rarely performed correctly. When it was enacted in 1958, there were no other limitations on deferrals under 403(b) plans. Deferrals under 403(b) plans, like deferrals under 401(k) plans, are now limited by Code sections 402(g) and 415. The MEA limitations are unnecessary, and it is inappropriate to have an additional limitation that applies only to 403(b) plans. Repeal of the MEA rules would achieve considerable simplification, and would bring the 401(k) rules and the 403(b) rules into closer conformity.

Second, in determining the number of years of service for purposes of section 403(b), the Code section 410(a)(3) definition used for qualified plans is not used: instead, the employee is credited with one year for each full year during which the individual was a full-time employee of the employer, and a fraction of a year (determined in accordance with regulations proscribed by the Secretary) for (1) each full year during which the individual was a part-time employee and (2) each part of a year during which such individual was a full-time or part-time employee. In no case shall the number of years of service be less than one.[256]

Finally, for purposes of the MEA calculation, unlike the contribution limitations under Code section 415, employer contributions are not taken into account until they are vested.[257]

E. *The Employer's Income Tax Deduction for Retirement Plan Contributions*

An employer that contributes to a tax-favored retirement plan for its employees is entitled to a current income tax deduction for the amount contributed.[258]

255. *Id.* § 403(b)(3); Treas. Reg. § 1.403(b)-1(e).

256. I.R.C. § 403(b)(4); *see also* Treas. Reg. § 1.403(b)-1(f) (discussing the measurement of full- and fractional-year employment).

257. I.R.C. § 403(b)(6).

258. *See id.* § 404.

However, there are limits on the amount that can be contributed, and these limits illustrate the conflict between good retirement policy and good tax policy. Good retirement policy would encourage employers to provide, and fully fund, generous retirement benefits for their employees, to enable them to live with dignity in retirement and to relieve the strain on Social Security and other public programs. Good tax policy requires that the current revenue cost of private retirement plans be reasonable, and that retirement plans provide sufficient benefits to employees in general to justify the revenue loss.[259]

The deduction limits, unlike the Code section 415 limitations on contributions, generally apply at the plan level, rather than on an employee by employee basis.

A contribution to a qualified plan, SEP or SIMPLE IRA will be deemed to have been made on the last day of a taxable year if the contribution is made on account of that year and is made by the due date, including extensions, of the employer's income tax return for the year.[260]

In applying the deduction limitations, the annual compensation taken into account is limited to the dollar maximum under Code section 401(a)(17), which is $170,000 for 2001.[261] In addition, the deduction limitations are coordinated with the Code section 415 contribution limitations so that the amount of any contributions otherwise taken into account for deduction purposes is reduced by any annual additions in excess of the section 415 limitations for the year.[262]

An employer that contributes more than the maximum deductible amount is allowed to carry over the excess and deduct it in a later year.[263] However, the employer is generally subject to an excise tax equal to 10% of the

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259. For fiscal year 1999, the tax expenditure for the net exclusion for pension contributions and earnings was estimated to be $76.1 billion. COMMITTEE ON TAX'N, 105TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR THE FISCAL YEARS 1999-2003, at 23 (Comm. Print 1998). For fiscal year 2000, the tax expenditure for the net exclusion for pension contributions and earnings is estimated to be $93.2 billion. *Id.*

260. I.R.C. § 404(h)(1)(B), (m); *see also* I.R.S. Notice 2000-6, 2000-2 C.B. 600.

261. I.R.C. § 404(l).

262. *Id.* §§ 404(j)(1), 415(c).

263. *See id.* § 404(a)(1)(E), (a)(3)(A)(ii).

nondeductible contribution, for each year that there is an excess amount in the plan.[264]

There is also a 6% excise tax on "excess contributions" to a 403(b)(7) custodial account. The "excess contribution" is the amount of the contributions (other than rollover contributions) in excess of the lesser of (1) the amount excludable from income under section 403(b) or (2) the maximum amount permitted by section 415.[265] This tax does not apply to excess contributions to a 403(b) annuity contract.

1. *Pension Plans.* Contributions are deductible in the taxable year when paid, if that year ends with or within a taxable year of the pension trust for which the trust is tax-exempt under section 501(a). In the case of a defined contribution pension plan (i.e., a money purchase or target benefit plan), the amount deductible is the amount necessary to satisfy the minimum funding standard for plan years ending with or within that taxable year, or for any prior plan year.[266]

The deduction limitations are coordinated with the Code section 415 contribution limitations so that the amount of any contributions otherwise taken into account for deduction purposes is reduced by any annual additions in excess of the section 415 limitations for the year. Accordingly, the effective deduction limitation is 25% of the total compensation (including pre-tax deferrals and cafeteria plan contributions) of the plan participants for the year in question.[267]

2. *Stock Bonus and Profit-Sharing Plans.* Contributions to one or more profit-sharing or stock bonus plans are

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264. *Id.* § 4972. The tax generally does not apply to tax-exempt employers. Also, I.R.C. § 4972(c)(6)(B) contains an exception for certain contributions to a defined contribution plan that are non-deductible solely because of § 404(a)(7). However, if contributions to a defined benefit plan were taken into account in determining the deductible amount, this rule applies only if the defined benefit plan has more than 100 participants. *Id.* § 4972(c)(6).

265. *Id.* § 4973. Section 4973 also applies to IRAs. Treas. Reg. § 1.408-1(c)(1) (1980).

266. *See* I.R.C. § 404(a)(1)(A). The same rule applies to I.R.C. § 403(a) annuity plans, if certain requirements are satisfied. *See id.* § 404(a)(2). If the plan year differs from the employer's taxable year, the employer has three alternatives. *See* Treas. Reg. § 1.404(a)-14(c).

267. I.R.C. §§ 404(j)(1), 415(c).

deductible in the taxable year when paid, if that year ends with or within a taxable year of the plan's trust for which the trust is tax-exempt under section 501(a). The maximum deductible amount is 15% of the compensation otherwise paid or accrued during the taxable year to the plan beneficiaries.[268]

There are special, higher deduction limits for contributions to a leveraged ESOP sponsored by a regular (C) corporation.[269] Also, certain dividends paid on employer securities held by an ESOP are deductible.[270]

The 15% limit for profit-sharing and stock bonus plans has been in effect for many years. It has become more problematic in recent years because of the enormous popularity of 401(k) plans and cafeteria plans. First, the "compensation" taken into account in calculating the deduction limit includes only compensation that is currently includible in the employee's gross income, so 401(k) deferrals and pre-tax cafeteria plan contributions are disregarded.[271] Second, the employee's elective 401(k) deferrals are treated as employer contributions for tax purposes, so they count toward the 15% limit.

The present rules should be modified in three respects. First, the compensation base should include pre-tax deferrals and cafeteria plan contributions. Second, 401(k) deferrals should not count towards the limit.[272] Finally,

268. *Id.* § 404(a)(3)(A). The "beneficiaries" include only those plan participants who actually share in the contribution for the year in question. *See* Treas. Reg. § 1.404(a)-9(c); Dallas Dental Lab, Inc. v. Comm'r, 72 T.C. 117, 126 (1979). The statute specifies an alternative maximum, namely the amount that the employer is required to contribute to a SIMPLE 401(k) plan under I.R.C. § 401(k)(11). I.R.C. § 404(a)(3)(A)(II). However, it does not seem that this would ever permit a larger deduction. If the employer has any unused pre-1987 limitation carryforward, the maximum is increased by that amount, subject to an overall maximum of 25% of covered compensation. *Id.* § 404(a)(3)(A)(v).

269. I.R.C. § 404(a)(9)(A)-(C).

270. *Id.* § 404(k).

271. *See id.* § 404(a).

272. Assume that employee A's compensation is $100,000, that he defers nothing under the plan, and that the employer contributes the maximum 15% of compensation to its 401(k) plan. Assuming that A's compensation is reasonable, the employer can deduct $115,000: $100,000 under Code section 162 and $15,000 under section 404. *See id.* §§ 162(a)(1), 404(a)(3)(A). Now assume, instead, that A defers the maximum $10,500 under the 401(k) plan, no other participant defers anything, and the employer still wishes to contribute 15% of compensation for all participants. Its section 162 deduction for A is $89,500, and its section 404 deduction is effectively limited to $23,925 (the $10,500

given that money purchase pension plans and profit-sharing plans are functionally equivalent, and are both defined contribution plans, the deduction limits should be the same for both. The current higher limit for money purchase plans results from their pre-ERISA classification as pension plans, and there is no longer any adequate justification for different deduction rules.

3. *Two or More Plans.* If an employer contributes, for the same year, to a defined contribution plan and a defined benefit plan, or to a money purchase (or target benefit) plan and a profit-sharing (or stock bonus) plan, and at least one employee participates in both plans, then the total deduction for contributions to both plans is limited to 25% of the taxable compensation of all employees who benefit under either plan or if greater, the defined benefit plan contribution required by the minimum funding rules.[273]

4. *SEPs.* The maximum deduction for a SEP is 15% of the compensation paid to the employees during the taxable year, if the SEP is maintained on a taxable year basis or during the calendar year ending with or within the taxable year if the SEP is maintained on a calendar year basis.[274] If the employer also has a profit-sharing or stock bonus plan, the maximum deduction under section 404(a)(3) is reduced by deductible SEP contributions made for profit-sharing or stock bonus participants.[275]

5. *SIMPLE IRAs.* SIMPLE IRA contributions are deductible for the taxable year with or within which ends the calendar year for which the contributions were made.[276]

F. *Contributions of Property*

In general, an employer's contribution to a qualified plan may be made in property rather than cash, in which event the amount deductible is the fair market value of the

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deferral plus 15% of ($100,000 - $10,500)), for a total of $113,425. Why should the employer's deduction be reduced because A elects to defer?

273. *Id.* § 404(a)(7).

274. *Id.* § 404(h)(1).

275. *Id.* § 404(h)(2).

276. *Id.* § 404(m)(2)(A).

property. However, the DOL position is that an in-kind contribution to a plan (including a plan that is not subject to the minimum funding rules) that reduces the employer's obligation to make a contribution measured in terms of cash amounts, constitutes a prohibited transaction[277] unless a statutory or administrative exemption applies.[278] In *Commissioner v. Keystone Consolidated Industries, Inc.*, the Supreme Court held that an employer's contribution of unencumbered real property to a defined benefit plan was a prohibited transaction.[279]

Except for rollovers, all contributions to an IRA (including a SEP or a SIMPLE IRA) must be in cash.[280]

G. *Code Section 415*

The "annual additions" allocated to an individual, under all defined contribution plans maintained by an employer (or by a group of related employers), may not exceed the lesser of 25% of the employee's compensation for the year in question or $35,000 (as adjusted for cost of living increases).[281] An annual addition is generally credited for a particular year if it is allocated to a participant's account under the terms of the plan as of any date within that year, provided that it is made within thirty days after the contribution due date for the taxable year with or within which the limitation year ends or, in the case of a tax-exempt employer, within five and a half months after the end of the taxable year.[282]

The "annual addition" includes all employer contributions, employee contributions (pre-tax or after-tax), and forfeitures allocated to the employee's accounts under

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277. *See* I.R.C. § 4975(c)(1)(A); ERISA § 406(a)(1)(A), 29 U.S.C. § 1106(a)(1)(A) (1994).

278. Dep't of Labor Interpretive Bulletin 2509.94-3, 59 Fed. Reg. 66,735, 66,736 (Dec. 28, 1994).

279. 508 U.S. 152, 159-60 (1993).

280. I.R.C. § 408(a)(1).

281. For this purpose, compensation includes pre-tax deferrals and cafeteria plan contributions. *Id.* § 415(c)(3)(D). A $30,000 limitation had been in effect since 1983, *see id.* § 415(c)(1), which increased to $35,000 for years ending in 2001. *See* I.R.S. Notice 2000-66, 2000-2 C.B. 600.

282. *See* Treas. Reg. § 1.415-6(b)(7) (as amended in 1994). For rules where the minimum funding standard has been waived, or where the contribution is made to reduce an accumulated funding deficiency, see Treas. Reg. § 1.415-6(b)(2)(v), (vi).

the plan. The annual addition does not include investment earnings allocated to the employee's accounts.[283] Section 415 applies to qualified plans, 403(a) plans, 403(b) plans and SEPs.[284]

Compliance with these limitations is a qualification requirement,[285] so a violation of section 415 can disqualify the plan. By contrast, in the case of a 403(b) plan, only the excess over the 415 limitation is currently taxable.[286]

Section 415(c) allows three special elections for participants in 403(b) plans maintained by educational organizations, hospitals, home health service agencies, health and welfare service agencies and churches (including conventions and associations of churches or church-controlled organizations).[287] The effect of making an election is to allow the electing participants a larger maximum contribution under the section 415 rules than would otherwise be permitted. There does not appear to be any good reason why participants in a 403(b) plan should be allowed a larger amount than participants in a qualified plan or, if a larger maximum were appropriate, why this special treatment should be limited to certain types of employer.

In the case of a 403(b) plan, the general rule is that the participant, not the employer, is deemed to maintain the plan, so that annual additions under the 403(b) plan would not be aggregated, in applying the 415 limits, with annual additions under a qualified plan sponsored by that employer.[288] However, (1) if the participant controls any employer (such as a medical practice owned by a physician who is employed by a medical school that has a 403(b)

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283. Annual additions include contributions allocated to an individual medical benefit account for a key employee under a pension or annuity plan to provide retiree health benefits described in Code Section 401(h). I.R.C. § 415(c)(1). In the case of an ESOP (as described in § 4975(e)(7)), for a year in which no more than one-third of the contributions deductible under § 404(a)(9) are allocated to HCEs, the annual addition does not include forfeitures of employer securities acquired with a loan, or employer contributions that are used to pay loan interest and are charged against the participant's account. *Id.* § 415(c)(6). There are also special rules for church plans. *Id.* § 415(c)(7).

284. *Id.* § 415(k)(1).

285. *Id.* § 401(a)(16).

286. *See* Treas. Reg. § 1.415-1(b)(2). That amount does, however, reduce the maximum exclusion allowance as provided in Code Section 403(b)(2). I.R.C. § 415(a)(2).

287. I.R.C. § 415(c)(4).

288. Treas. Reg. §§ 1.415-7(h)(1)(i), 1.415-8(d)(1).

plan), the 403(b) plan is treated as a defined contribution plan maintained by both the participant and the controlled employer;[289] and (2) if the participant has made the "C" election under Code section 415(c)(4)(C), the 403(b) plan is treated as maintained both by the employer and the participant.[290]

These special rules for 403(b) plans are not well understood, and they lead to anomalous results. For instance: (1) A physician is employed by a tax-exempt hospital. He does not control the hospital, or any other employer, and does not make the C election. The hospital sponsors both a qualified money purchase plan and a 403(b) plan. Contributions made on behalf of the physician under the two plans are not aggregated. (2) The facts are as in (1), except that the hospital sponsors a qualified 401(k) plan instead of a 403(b) plan. Contributions made on behalf of the physician under the two plans are aggregated. (3) A physician is employed by a tax-exempt hospital, and also owns a separate medical practice. The physician does not control the hospital. The hospital sponsors a 403(b) plan, and the medical practice sponsors a 401(k) plan. Contributions made on behalf of the physician under the two plans are aggregated. (4) The facts are as in (3), except that the hospital sponsors a qualified money purchase plan instead of a 403(b) plan. Contributions made on behalf of the physician under the two plans are not aggregated.

There is no policy reason for these distinctions. The rules for 403(b) plans should be conformed to the qualified plan rules. This is appropriate from a policy viewpoint, and also achieves some simplification.

H. *The Minimum Funding Rules*

One of the primary goals of ERISA was to improve the funding of defined benefit plans. Accordingly, ERISA enacted minimum funding rules.[291] If the employer fails to

289. *Id.* §§ 1.415-7(h)(2)(i), 1.415-8(d)(2).

290. *Id.* §§ 1.415-7(h)(2)(ii), 1.415-8(d)(2).

291. *See generally* I.R.C. § 412; ERISA §§ 301-307, 29 U.S.C. §§ 1081-1085(b) (1994 & Supp. III 1997). The deadline for making the contribution for a plan year is eight and a half months after the end of the plan year. I.R.C. § 412(c)(10); Treas. Reg. § 11.412(c)-12(b). If the employer is even one day late, the full excise tax is payable. This deadline is not always the same as the deadline for making deductible contributions. *See* I.R.C. § 404(a)(6).

contribute to the plan an amount at least equal to the required minimum, it becomes subject to a 10% first tier excise tax and, unless the underfunding is corrected, a 100% second tier excise tax.[292]

Under current law, the minimum funding rules also apply to defined contribution (money purchase and target benefit) pension plans, but do not apply to profit-sharing or stock bonus plans.[293] There is no good reason to apply the minimum funding rules, which were designed for defined benefit plans, to any type of defined contribution plan. From the employee's viewpoint, and also as a matter of pension policy, there is no relevant distinction between (1) an employer's failure to make a contribution required by the terms of a money purchase plan (for example, 5% of compensation), including a contribution required by law (for example, a top-heavy minimum contribution) and (2) an employer's failure to make a contribution required by the terms of a 401(k) plan (for example, a 50% matching contribution), including a contribution required by law (for example, a top-heavy minimum contribution or a required contribution to a safe harbor or SIMPLE 401(k) plan).

Yet, under current law the former is a violation of the minimum funding rules but the latter is not. The purpose of the minimum funding rules is to achieve adequate funding of defined benefit plans. Accordingly, I recommend that the minimum funding rules be limited to defined benefit plans.

A plan which is subject to the minimum funding standards may not be amended to provide for a substantial reduction in the rate of future benefit accrual unless, after adoption of the plan amendment and at least fifteen days before its effective date, the administrator provides a written notice, setting forth the amendment and its effective date, to each participant, each alternate payee under a "qualified domestic relations order" (QDRO), and each employee organization representing participants.[294] The applicability of this rule should not depend on whether the plan is subject to the minimum funding rules. Instead, the rule should apply to (1) defined benefit plans and (2) defined contribution plans under which the employer has

292. I.R.C. § 4971.
293. *See id.* § 412(h).
294. ERISA § 204(h), 29 U.S.C. § 1054(h) (1994).

committed itself, or is required by law, to provide a specified rate of nonelective or matching contributions.

I. *Vesting Issues*

Another major change enacted by ERISA was a significant acceleration of the rate at which benefits attributable to employer contributions are required to vest. Permissible vesting schedules were further accelerated, in the case of top-heavy plans, by the Tax Equity and Fiscal Responsibility Act in 1982 and, for all plans, by the Tax Reform Act of 1986.[295]

Under current law, benefits attributable to employee contributions (elective deferrals or after-tax contributions) must be fully vested at all times.[296] With respect to benefits attributable to employer contributions, a plan is required to provide either (1) full vesting after no more than five years of service; or (2) a graded vesting schedule that provides, at a minimum, 20% vesting after three years, 40% after four years, 60% after five years, 80% after six years, and 100% after seven years.[297]

A top-heavy plan is required to provide either (1) full vesting after no more than three years of service; or (2) a graded vesting schedule that provides, at a minimum, 20% vesting after two years, 40% after three years, 60% after four years, 80% after five years, and 100% after six years.[298]

There are two basic problems with this scheme. First, the definition of "year of service" for vesting purposes is essentially the same as for eligibility to participate, so the employer can require the employee to have 1000 hours of service, during a twelve month vesting computation period, in order to be credited with a year of service for vesting purposes.[299] So, long term part-time or seasonal employees may never vest.[300] Second, the average job tenure is now

295. *See* I.R.C. § 411; ERISA §§ 203-204, 29 U.S.C. §§ 1053-1054 (1994 & Supp. III 1997).

296. I.R.C. § 411(a)(1); ERISA § 203(a)(1), 29 U.S.C. § 1053(a)(1) (1994).

297. I.R.C. § 411(a)(2); ERISA § 203(a)(2), 29 U.S.C. § 1053(a)(2) (Supp. II 1996).

298. I.R.C. § 416(b); *see also supra* Part III.C.

299. I.R.C. § 411(a)(5); ERISA § 203(b), 29 U.S.C. § 1053(b) (1994).

300. *See CRS Report*, *supra* note 11, at tbl.8 (referring to "the continuing disadvantage that women face with respect to future pension income because their employment is more likely to be part-year or part-time. . . . Policy options include shortening the maximum length of time before pension participants are

less than five years, so many employees—a disproportionate number of whom are low-paid—terminate employment, more than once during their working lifetimes, before being fully vested.

The accelerated vesting required by ERISA significantly increased the percentage of private pension plan participants who were vested, and the further changes enacted by the Tax Reform Act of 1986 are likely to have a similar effect.[301] I suggest that it is time again to shorten the length of time that a plan may require for full vesting, at least for defined contribution plans. One relatively modest change would be to require all qualified defined contribution plans to satisfy one of the two top-heavy vesting schedules (three year cliff vesting or two to six year graduated vesting), which would have the additional simplification advantage of eliminating another difference between top-heavy and non-top-heavy defined contribution plans. Another, more radical change would be to eliminate the 1000 hours of service test, and require either that employees be given vesting credit for their period of service, regardless of the number of hours worked (as is the case under the elapsed time method of crediting service)[302] or to reduce the 1000 hour threshold significantly to, for instance, 250 hours or 500 hours. Part-time and seasonal employees already receive lower Social Security benefits because they have lower earnings than full-time employees: this disadvantage should not be compounded by shutting them out of the private pension system.

All IRAs, including SEPs and SIMPLE IRAs, must be fully vested at all times.[303]

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fully vested in their retirement benefits and promoting portability of retirement benefits").

301. *See* John R. Woods, *Pension Vesting and Preretirement Lump Sums Among Full-Time Private Sector Employees*, 56 SOC. SEC. BULL. 3 (1993); *see also* EMILY S. ANDREWS, THE CHANGING PROFILE OF PENSIONS IN AMERICA 156 (1985).

302. *See generally* Treas. Reg. § 1.410(a)-7 (1980) (describing the elapsed time method of measuring service).

303. I.R.C. § 408(a)(4); Treas. Reg. § 1.408-2(e)(4).

J. *Nondiscrimination Issues*[304]

In the context of retirement plans, nondiscrimination has a specialized meaning, and is strictly a tax issue, which is not addressed by ERISA. The Code provides that a qualified plan may not discriminate in favor of "highly compensated employees" (HCEs).[305] The premise underlying this requirement, which originated (in slightly different form) in the Revenue Act of 1942,[306] is that the substantial tax expenditure resulting from the favorable tax treatment afforded to retirement plans is justified only if significant benefits are provided to rank and file employees.[307] In 1986, this requirement was extended to employer contributions to a 403(b) plan but, fourteen years later, it is still not clear how the rules apply to 403(b) plans.[308]

In its simplest form, nondiscrimination in this context requires that (1) a defined contribution plan may not

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304. A comprehensive discussion of the nondiscrimination rules would require a separate article, so this paper only addresses the topic briefly. Numerous articles discuss the desirability or otherwise of numerical nondiscrimination rules. *See, e.g.*, Joseph Bankman, *The Effect of Anti-Discrimination Provisions on Rank-and-File Compensation*, 72 WASH. U. L.Q. 597 (1994); Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988); Michael W. Melton, *Making the Nondiscrimination Rules of Tax-Qualified Retirement Plans More Effective*, 71 B.U. L. REV. 47 (1991); Bruce Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419 (1984).

305. I.R.C. § 401(a)(4). The term "highly compensated employee" is defined in I.R.C. § 414(q). Essentially, a HCE is any person who (1) earned at least $80,000 (indexed) from the employer during the preceding year (and, if the employer so elects, was among the highest paid 20% of employees) or (2) owned, directly or by attribution (for instance, from a family member), more than 5% of the employer at any time during the current or preceding year. Any plan participant who is not a HCE is a NHCE.

306. *See* I.R.C. § 165(a)(4) (1939); *see also* Revenue Act of 1942, § 162, *reprinted in* 1943 C.B. 479.

307. One may question whether the nondiscrimination rules have been effective, in view of the employee coverage data. *See supra* note 10 and accompanying text. Further, one may also question whether the current tax expenditure related to retirement plans is justified by the number of employees who actually benefit under the current system. *See supra* note 43 and accompanying text. Nancy Altman has argued persuasively that an "anachronistic taxpayer abuse perspective" was the original reason for, and still infuses, the nondiscrimination rules. *See* Altman, *supra* note 29.

308. I.R.C. § 403(b)(12)(i). *See generally* I.R.S. Notice 89-23, 1989-1 C.B. 654; I.R.S. Notice 90-73, 1990-2 C.B. 353; I.R.S. Notice 92-36, 1992-2 C.B. 364; I.R.S. Announcement 95-48, 1995-23 I.R.B. 13; I.R.S. Notice 96-64, 1996-2 C.B. 229.

provide contributions for HCEs that are higher, as a percentage of compensation, than the contributions made for NHCEs; and (2) a defined benefit plan may not provide benefits for HCEs that are higher, as a percentage of compensation, than the benefits provided for NHCEs.[309]

Even in its simplest form, this rule is not invulnerable to challenge: why should the tax system subsidize a contribution of $30,000 for an employee making $150,000 per year if the plan provides a contribution of only $1000 for an employee making $20,000 per year? The HCE presumably has other assets, and can save at least part of his or her disposable income for retirement. Even accepting that, under a voluntary pension system, there must be incentives for the decision-makers (who are HCEs) to adopt a plan, should the plan not be required to provide at least a minimum level of contributions or benefits for low-paid employees?

However, under current law, the nondiscrimination rules permit contributions or benefits for HCEs that can be significantly greater, in proportion to compensation, than those provided for NHCEs. First, the nondiscrimination rules are linked to the employee coverage rules: a plan will satisfy the nondiscrimination rules if it provides a "nondiscriminatory" benefit to a group of employees that satisfies the employee coverage rules of Code section 410(b).

Second, the plan's contributions or benefits can be "integrated" or coordinated with Social Security, the effect of which is to increase the contributions or benefits for the HCEs in relation to those for the NHCEs.[310] Prior to the Tax Reform Act of 1986, these rules could be defended, with some degree of plausibility, on the basis that the overall level of contributions or benefits, under Social Security and

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309. An ESOP may not be considered together with another plan for purposes of satisfying I.R.C. § 401(a)(4) or (5) or 410(b) unless (1) the ESOP and the other plan existed on November 1, 1977 or (2) a special rule for combined ESOPs is satisfied. *See* Treas. Reg. §§ 1.410(b)-7(c)(2) (as amended in 1994), 54.4975-11(e) (as amended in 1979).

310. *See* I.R.C. § 401(l); Treas. Reg. § 1.401(l). An ESOP adopted after November 1, 1977, may not be integrated and Code section 401(l) is not available with respect to elective contributions under a qualified CODA, for employee or matching contributions subject to § 401(m) or to salary reduction contributions under a SARSEP. *See* Treas. Reg. §§ 1.401(l)-1(a)(4), 54.4975-11(a)(7)(ii).

the private retirement plan, was relatively level.[311] The "permitted disparity" rules of current law are basically indefensible, and are extremely complex. Accordingly, I recommend that they be repealed in their entirety.

Third, the statute provides that the plan is nondiscriminatory if either the contributions to the plan, or the benefits under the plan, are nondiscriminatory. Accordingly, the regulations specifically permit "cross-testing", under which a defined benefit plan may be tested by reference to the contributions made on behalf of each participant, rather than on the basis of the benefits actually provided by the plan. This could be advantageous if the HCEs, as a group, were younger than the NHCEs.

Alternatively, as is much more common, a defined contribution plan may be tested by reference to the projected benefits for each participant at normal retirement age, rather than on the basis of the contributions actually made to the plan.[312] This is the basis of the new comparability approach, and is advantageous if, as is usually the case, the HCEs as a group are older than the NHCEs.

For example, assume that the employer has two owners, aged fifty and fifty-five, and six employees, ranging in age from twenty-one to sixty.[313] Each owner earns $150,000, and the total compensation of the six employees is $165,000, so the owners have 65% of the total compensation of the plan participants, which is $465,000. The maximum deductible profit-sharing contribution is 15% of $465,000, or $69,750.

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311. Even under prior law, the conceptual basis for integration was shaky at best:

> Employers are paying a percentage of their workers' salaries into Social Security. However, the payment is a *tax*, not a pension contribution. The benefits for which the employer is contributing are not for its current workers, but for workers now retired, from an earlier generation, perhaps before this employer was even in business. To construe the employer's contribution as something other than a general tax and the employee's benefit as somehow purchased in part by the employee's employer is carrying a useful political fiction to an illogical extreme.

Altman, *supra* note 29, at 504.

312. An ESOP may not be cross-tested. *See* Treas. Reg. §§ 1.401(a)(4)-1(b)(2)(ii), 1.401(a)(4)-8(b)(1).

313. *See* Orszag, *supra* note 143.

Under a traditional profit-sharing plan, where the contribution is allocated in proportion to compensation, each participant would receive an allocation equal to 15% of his or her compensation. The owners would receive 65% of the contribution, or $45,000, and the six employees would receive a total of $24,750.

If the plan were "integrated" with Social Security, by using the permitted disparity rules of Code section 401(l), the total contribution for the two owners would increase slightly, to $47,985, and the total contribution for the six employees would decline slightly, to $21,765. The owners' share of the total contribution has increased to 69%.

If the plan uses an age-weighted allocation formula, under which the allocation is based on age as well as compensation, the total contribution for the two owners would again increase slightly, to $48,986 and the total for the six employees declines slightly, to $20,764. The owners' share is now 70%.

Under a new comparability formula, the allocations change dramatically: each owner receives a $30,000 allocation (20% of compensation), while the six employees receive only the top-heavy minimum, 3% of compensation. The owners' share has now increased dramatically, to 92%.

Cross-testing is made easier by the fact that a plan can be tested on the basis of "rate groups" rather than on the basis of the entire plan.[314] Under this approach, provided that the group of employees that receives each level of benefits under the plan satisfies a liberalized version of the nondiscriminatory classification test, then that level of benefits is nondiscriminatory.[315]

314. A rate group exists for each HCE participating in the plan, and consists of that HCE and all other participants (HCEs and NHCEs) whose allocation rate (if the plan is being tested on the basis of contributions) or equivalent benefit accrual rate (if the plan is being tested on the basis of benefits, as would be the case for a cross-tested defined contribution plan) is equal to or greater than the HCE's rate. *See* Treas. Reg. §§ 1.401(a)(4)-2(c)(1), 1.401(a)(4)-3(c)(1).

315. The ratio percentage of the rate group (percentage of NHCEs in the group divided by percentage of HCEs in the group) must equal or exceed the lesser of (1) the ratio percentage of the plan or (2) the midpoint between the safe and unsafe harbor percentages applicable to the plan. *See* Treas. Reg. §§ 1.401(a)(4)-2(c)(3), 1.401(a)(4)-3(c)(2). Thus, for instance, if 90% of the employees of the employer are NHCEs, the safe harbor percentage is 27.5% and the unsafe harbor percentage is 20%, giving a midpoint of 23.75%. Accordingly, if the rate group includes 100% of the HCEs, it need only include 23.75% of the NHCEs. If the rate group includes only 50% of the HCEs, it need only include 11.875% of the NHCEs. These relatively brief extracts from the

This technique is based upon, and was encouraged by, the IRS regulations.[316] The IRS has recently indicated discomfort with the ways in which the technique is being used,[317] and recently proposed regulations imposing new requirements on new comparability plans.[318]

SEP contributions may not discriminate in favor of any HCE. Employer contributions, other than salary reduction contributions, must bear a uniform relationship to compensation not exceeding the dollar limit (currently $170,000) under section 401(a)(17), except that the permitted disparity rules may be used.[319]

The nondiscrimination test for SARSEPs is more restrictive than the actual deferral percentage (ADP) test for elective deferrals under a 401(k) plan. First, the only available test is the 125% test: the alternative test is not available.[320] Second, the deferral percentage of each individual HCE, rather than the average for the HCEs as a group, is subject to this 125% limit.[321] Third, employer contributions can be used to satisfy the ADP test, but this is not possible under a SARSEP.[322]

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nondiscrimination regulations will, I hope, give the reader a sense of the crazy world of nondiscrimination testing, where the hapless plan administrator (Alice) tries to satisfy the mathematical cravings of the Treasury Department (the Red Queen), while being uncomfortably aware of the sanction for failure ("Off with her head!").

316. *See* Treas. Reg. § 1.401(a)(4)-8; *see also 1991 IRS Memo on Defined Contribution Plan Allocations to Highly Compensated Employees*, TAX NOTES TODAY, Oct. 17., 2000, *at* 2000 TNT 201-58 ("In a 1991 legal memo, an IRS attorney concluded that the regulations under section 401(a)(4) could encourage schemes for making disparate allocations to highly compensated employees under defined contribution plans.").

317. *See* I.R.S. Notice 2000-14, 2000-1 C.B. 737.

318. *See* Nondiscrimination Requirements for Certain Defined Contribution Retirement Plans, 65 Fed. Reg. 59,774 (proposed Oct. 6, 2000) (to be codified at 26 C.F.R. pt. 1). A public hearing was held on January 25, 2001. *See* Lee A. Sheppard, *New Comparability Plan Rules and Cross-Testing Generally*, 89 TAX NOTES 336 (2000).

319. I.R.C. § 408(k)(3); *see also* Priv. Ltr. Rul. 84-41-067 (July 12, 1984) (stating that SEP contributions may be based on hours worked).

320. I.R.C. § 408(k)(6)(A).

321. *Id.* § 408(k)(6)(A).

322. *Id.* § 408(k)(6)(D).

K. *Incidental Benefits*[323]

Under the pre-ERISA regulations, profit-sharing plans may provide "incidental" life and health insurance benefits.[324] Pension plans may provide "incidental" life insurance protection, and may also provide health insurance for retirees (and their spouses and dependents), but not for active employees.[325] Second to die life insurance is permitted in a profit-sharing plan.[326] However, the IRS has ruled that a pension plan which permits a participant to invest a portion of his or her account in a life insurance policy on the life of another person will not qualify.[327]

There is no good reason for these differences, but then there is really no good reason why qualified plans should be complicated by including ancillary benefits unrelated to the primary purpose of the plan—providing retirement income:

> It appears that fewer qualified plans now buy life insurance than in the past. The Department of Labor frequently has expressed its concerns about defined contribution plans investing in cash value insurance. Few plans have ever provided health insurance. Accordingly, we suggest that the rules allowing plans to provide incidental benefits be repealed. This would eliminate some complexity and would further the goal of uniform rules for all retirement plans, because IRAs are not allowed to provide these incidental benefits. These benefits can be provided easily under a separate welfare plan that is not subject to all of the complex pension rules.[328]

L. *Special Rules for Owner-Employees*

Before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), plans covering "owner-

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323. *See generally* David W. Powell, *Life Insurance in 403(b) Plans*, *in* LIFE INSURANCE ANSWER BOOK FOR QUALIFIED PLANS AND ESTATE PLANNING (Gary S. Lesser & Lawrence C. Starr eds., 2d ed. 1999 & Supp. 2001).

324. *See* Treas. Reg. § 1.401-1(b)(1)(ii) (as amended in 1976).

325. I.R.C. § 401(h); Treas. Reg. §§ 1.401-1(b)(1)(i), 1.401-14(c)(1).

326. Priv. Ltr. Rul. 84-45-095 (Aug. 13, 1984); Treas. Reg. § 1.401-1(b)(1)(ii).

327. *See* Rev. Rul. 69-523, 1969-2 C.B. 90; *see also* John J. McFadden & Stephan R. Leimberg, *Second-Death Life Insurance in Profit Sharing Plans*, 58 N.Y.U. INST. FED. TAX'N, EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION, at 11-1 (2000).

328. Pratt & Bennett, *supra* note 41, at 5-46 to 5-47 .

employees"[329] and other self-employed individuals were subject to significantly more restrictive rules than other plans. Since TEFRA, most of the differences have been eliminated, but several distinctions remain. There is no policy reason for these remaining distinctions, and their elimination has become more important because of the increasing popularity of limited liability companies (LLCs).

The remaining differences are as follows: (1) contributions made on behalf of an owner-employee may be made only with respect to earned income derived from the trade or business with respect to which the plan is established;[330] (2) loans to owner-employees (or related parties) are not exempt from the prohibited transaction rules;[331] (3) the definition of "earned income" of a self-employed individual does not correspond precisely to the "compensation" used for employees;[332] (4) for a self-employed individual, separation from service is not, but disability is, a triggering event for lump sum distribution treatment (for an employee, the reverse is true);[333] and (5) deductible contributions on behalf of a self-employed individual are limited to his or her earned income derived from the trade or business with respect to which the plan is established, and may not be used to buy insurance.[334]

These few remaining special rules should be repealed.

M. *Investment of Plan Assets*

As a general rule, a qualified plan has a very broad range of permissible investments. The only limitations are as follows: (1) the plan and its fiduciaries must comply with the prudence, diversification and prohibited transaction rules, and with any limitations imposed by the plan documents, and must avoid engaging in any "prohibited

329. The term "owner-employee" is defined in I.R.C. § 401(c)(3). If the definition retains any significance, it should be simplified. At present the term includes sole proprietors, more than 10% partners (including members of an LLC that has elected to be taxed as a partnership) and more than 5% S Corporation shareholders. I.R.C. § 401(c)(3).

330. *Id.* § 401(d).

331. *Id.* § 4975(f)(6)(A); ERISA § 408(d)(1), 29 U.S.C. § 1108(d)(1) (1994 & Supp. III 1997).

332. I.R.C. § 401(c)(2)(A).

333. *Id.* § 402(e)(4)(D).

334. *Id.* § 404(a)(8), (e).

transaction";[335] (2) there are limitations on the acquisition and holding of employer securities and employer real property[336]; (3) the amount invested in life insurance contracts must be limited, so that the death benefit remains "incidental";[337] (4) acquisition of a collectible, by an individually directed account, is treated as a taxable distribution.[338]

The investments available to a 403(b) plan are much more limited: unless the employer is a church, the plan may invest only in annuity contracts issued by an insurance company or in regulated investment company stock (mutual funds).[339] However, if the plan is a defined contribution program, and the employer is a church, or a convention or association of churches, including a church-controlled organization, the employer may maintain a retirement income account,[340] which has all of the investment alternatives available to a qualified plan and, if it is exempt from ERISA (as most church plans are), will not be subject to the ERISA restrictions. It would, however, be subject to any restrictions imposed by state law.

A SEP or SIMPLE IRA has a much broader range of permissible investments than a 403(b) plan, but is subject to the investment restrictions that apply to all IRAs (for example, no life insurance and no loans to the participant), and acquisition of a collectible is treated as a taxable distribution.[341] An IRA must also limit investment in qualifying employer securities and qualifying employer real property to 10% of its assets.

There are no explicit investment restrictions for 457 plans. If the plan is exempt from ERISA, then it will be subject to any limitations imposed by state law.

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335. I.R.C. § 4975; ERISA §§ 404(a)(1)(B)-(D), 406, 29 U.S.C. §§ 1104(a)(1)(B)-(D), 1106 (1994).

336. ERISA § 407, 29 U.S.C. § 1107 (1994 & Supp. III 1997). The limitations relating to employer securities generally do not apply to any defined contribution plan that is an "eligible individual account plan." *Id.* § 407(b), 29 U.S.C. § 1107(b) (1994).

337. *See* Treas. Reg. § 1.401-1(b)(1)(i)-(ii) (as amended in 1976).

338. I.R.C. § 408(m).

339. *Id.* § 403(b)(1), (7).

340. *Id.* § 403(b)(9).

341. *Id.* § 408(m).

There is no reason why 403(b)plans should have fewer investment options than qualified plans, and the existing restrictions should be repealed. Undoubtedly, many sponsors of 403(b) plans will, like many 401(k) plan sponsors, continue to invest with insurance companies and mutual fund families, but they should have the opportunity to use other investment managers.

N. *Prohibited Transactions*

Retirement plans are subject to extensive prohibited transaction rules under both the Code and ERISA.[342] The prohibition is categorical, and does not depend on any finding that the transaction is inappropriate, or unfair to the plan. The prohibitions are so broad that it would be impossible to operate any plan without an extensive and complex set of statutory and regulatory exemptions.[343] In addition, although twenty-six years have passed since ERISA was enacted, the precise scope of some of the prohibitions and exemptions is still not clear, introducing undesirable uncertainty into plan administration and conferring enormous power on the DOL, the agency responsible for enforcing the rules. I suggest that a comprehensive review of these rules is long overdue.

If a qualified plan or 403(b) plan engages in a prohibited transaction, the penalty is a first tier excise tax equal to 15% of the "amount involved";[344] if the transaction is a continuing one (such as a prohibited loan), the first tier tax may be imposed for each year the prohibited transaction continues.[345] If the transaction is not corrected, after notice from the IRS, a 100% second tier excise tax may be imposed.[346]

An IRA (including a SEP or a SIMPLE IRA) loses its tax exemption, as of the first day of the taxable year in

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342. *Id.* § 4975; ERISA § 406, 29 U.S.C. § 1106 (1994).

343. I.R.C. § 4975(c)(2), (d); ERISA § 408, 29 U.S.C. § 1108 (1994 & Supp. V 1999). It is also possible for a fiduciary to apply to the DOL for an individual exemption. I.R.C. § 4975(c)(2), (d); ERISA § 408, 29 U.S.C. § 1108. As Langbein and Wolk ask, "[o]ught a regulatory scheme to be so overinclusive that it is unworkable without an extensive law of exemptions?" JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 705 (3d ed. 2000).

344. I.R.C. § 4975(a).

345. *Id.* § 4975(f)(2).

346. *Id.* § 4975(b).

which the owner or his or her beneficiary engages in a prohibited transaction.[347] The IRA is treated as distributing all of its assets as of that date. The same result occurs if the owner borrows under or by use of an individual retirement annuity contract.[348] If the owner pledges an IRA as security, the portion so used is treated as having been distributed.[349]

Application of the prohibited transaction rules to qualified plans is often difficult: application to IRAs of rules that were designed for qualified plans, a very different type of retirement vehicle, is often virtually impossible.[350] IRA providers and owners are not generally aware of the rules, and even with expert advice it can often be difficult to determine whether a proposed transaction is in fact prohibited. In that context, the sanction is totally disproportionate and should be replaced by an excise tax similar to the prohibited transaction excise tax applicable to qualified plans.

An alternative approach would be to consider the extent to which prohibited transaction rules are needed for IRAs. If so, then Congress should enact special prohibited transaction rules, separate from the qualified plan rules. The frequent attempts within the retirement plan rules to stretch a provision designed for one type of plan to cover another type almost invariably lead to confusion and noncompliance.

O. *Domestic Relations*

Benefits under qualified plans, and other retirement plans subject to ERISA, may be divided without current taxation, in connection with a divorce or other matrimonial proceeding, by obtaining, from the court or agency that has jurisdiction under state domestic relations law, a "qualified domestic relations order" or QDRO.[351] Similarly, an interest in an IRA (including a SEP or SIMPLE IRA) may be

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347. *Id.* § 408(e)(2); Treas. Reg. § 1.408-1(c)(2) (1980).
348. I.R.C. § 408(e)(3); Treas. Reg. § 1.408-1(c)(5).
349. I.R.C. § 408(e)(4); Treas. Reg. § 1.408-1(c)(4).
350. *See, e.g.*, Zabolotny v. Comm'r, 7 F.3d 774 (8th Cir. 1993) (suggesting that the prohibited transaction rules are seriously flawed even in their application to qualified plans).
351. I.R.C. § 414(p); ERISA § 206(d)(3), 29 U.S.C. § 1056(d)(3) (1994). A similar procedure is available for governmental plans and church plans that are not subject to the QDRO rules.

transferred tax-free, to the IRA owner's spouse or former spouse, provided that the transfer is under a "divorce or separation instrument".[352]

Unfortunately, despite the importance of these rules, they are not well understood, either by plan administrators or matrimonial attorneys, and the poor drafting of the QDRO rules, in particular, has given rise to a large volume of litigation.[353] In addition, there are differences between the IRA rules and the QDRO rules,[354] which may be a trap for matrimonial lawyers who assume that the rules are the same. I suggest that there should be a thorough review of these rules, with a view to making them simpler to apply in practice, and that this review should include consideration of eliminating these differences, to the extent possible.[355]

IV. WHEN CAN BENEFITS BE PAID?

If a qualified plan makes a distribution at a time when no distribution is permitted, this is a disqualifying defect. Different rules apply to different types of plan. Any after-tax employee contributions can generally be withdrawn at any time, if the plan so provides.

Pension plans (defined benefit or defined contribution) generally are not allowed to make in-service distributions, prior to plan termination, unless the employee has attained normal retirement age.[356] Profit-sharing plans, stock bonus plans and ESOPs may (with the exception of elective deferrals under a 401(k) plan and certain other amounts,

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352. I.R.C. § 408(d)(6).

353. *See* David A. Pratt, *Focus on . . . Qualified Domestic Relations Orders*, 6 J. PENSION BENEFITS 40, 40-52 (1999).

354. For example, I.R.C. § 408(d(6) does not provide for a tax free transfer to anyone other than the IRA owner's spouse or former spouse, such as a child. Also, there is no provision allowing a withdrawal from one spouse's IRA to be tax free if "rolled over" to the other spouse's IRA. *See, e.g.*, Rodoni v Comm'r, 105 T.C. 29 (1995).

355. Despite the many areas of concern that have become evident since QDROs were introduced by REA in 1984, no regulations have even been proposed. The DOL has issued an excellent booklet, QDROS: THE DIVISION OF PENSIONS THROUGH QUALIFIED DOMESTIC RELATIONS ORDERS. *See* I.R.S. Notice 97-11, 1997-1 C.B. 379 (providing sample QDRO language). However, neither the Notice nor the DOL booklet has the authority of a regulation.

356. *See* Treas. Reg. § 1.401-1(b)(1)(i) (as amended in 1976); Priv. Ltr. Rul. 85-41-095 (July 18, 1985); Rev. Rul. 69-277, 1969-1 C.B. 116; Rev. Rul. 71-24, 1971-1 C.B. 114. According to Rev. Rul. 78-120, a plan may specify that any age less than sixty-five is the normal retirement age. *See infra* Part IV.A.

such as QMACs, QNECs and safe harbor 401(k) contributions) incorporate liberal in-service distribution rules.[357] The rules for 403(b) plans differ, depending on whether the funds are invested in annuity contracts or mutual funds.[358] These rules are not well understood: many people believe, incorrectly, that a distribution from a profit-sharing plan may be made at any time at all, if the plan so provides. The differences in the distribution rules, applicable to different types of defined contribution plan, serve no useful purpose, and are a trap for the unwary. In addition, they fail to fulfill the goal of preserving funds for retirement, as a large proportion of pre-retirement distributions are simply spent, rather than being transferred to another retirement program, such as a rollover IRA.

IRAs (including SEPs and SIMPLE IRAs) have no such restrictions. Indeed, one of the fundamental weakness of both SEPs and SIMPLE IRAs, as small business retirement arrangements, is that the employer is *not allowed* to place any restrictions on the employee's ability to withdraw the funds at any time.

A. *Pension Plans*

Under a pension plan (defined benefit or defined contribution), distributions can be made only upon the occurrence of one of the following events:[359] (1) death of the participant; (2) disability of the participant; retirement; severance from employment;[360] (3) termination of the plan;[361] and (4) attainment of normal retirement age without terminating employment, if the plan so provides.[362]

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357. *See* Treas. Reg. § 1.401-1(b)(1)(ii) ("A profit-sharing plan . . . must provide a definite predetermined formula . . . for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment."); *see also* Rev. Rul. 60-323, 1960-2 C.B. 148 (1960) (modifying Rev. Rul. 56-693, 1956-2 C.B. 282 (1956)). For a more detailed discussion, see *infra* Parts IV.B, IV.C.

358. See I.R.C. § 403(b)(7).

359. *See* Treas. Reg. § 1.401-1(b)(1)(i).

360. *See* Rev. Rul. 56-693, 1956-2 C.B. 282; Rev. Rul. 74-417, 1974-2 C.B. 131 (holding that benefits may, in certain circumstances, be distributed from a pension plan prior to severance from employment).

361. *See* I.R.C. § 401(a)(20).

362. *See* Rev. Rul. 71-24, 1971-1 C.B. 114.

Payments can be made to an alternate payee under a QDRO, even if none of the above events has occurred, if the QDRO and the plan so provide.[363] There are also special limits on the amount that can be distributed to certain highly compensated employees.[364]

B. *Profit-Sharing, 401(k), and Stock Bonus Plans*

Under a profit-sharing, 401(k) or stock bonus plan, benefits (other than those attributable to elective deferrals) can be distributed upon the occurrence of any of the following events:[365] (1) death of the participant; (2) disability of the participant; (3) retirement; (4) termination of employment; (5) termination of the plan;[366] (6) attainment of normal retirement age without terminating employment, if the plan so provides; (7) attainment of a stated age; (8) occurrence of a stated event such as hardship,[367] layoff, partial plan termination or illness; and (9) accumulation of funds for a fixed number of years.[368]

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363. I.R.C. § 414(p)(10); Treas. Reg. § 1.401-13(g)(3). Regardless of the terms of the plan, payment must generally be available to an alternate payee at the participant's "earliest retirement age," regardless of whether the participant has terminated employment. *See* I.R.C. § 414(p)(4); ERISA § 206(d)(3)(E), 29 U.S.C. § 1056(d)(3)(E) (1994); Treas. Reg. § 1.401-13(g)(3). The "earliest retirement age" means the earlier of (1) the date on which the participant is entitled to a distribution under the plan, or (2) the later of the participant's 50th birthday, or the earliest date on which the participant could begin receiving benefits if he or she terminated employment. I.R.C. § 414(p)(4)(B); ERISA § 206(d)(3)(E)(ii), 29 U.S.C. § 1056(d)(3)(E)(ii).

364. *See* Treas. Reg. § 1.401(a)(4)-5(b); Rev. Rul. 92-76, 1992-2 C.B. 76. A money purchase plan that has an accumulated funding deficiency or an unamortized funding waiver must comply in operation with the early termination restrictions usually applicable to defined benefit plans. Treas. Reg. § 1.401(a)(4)-5(b)(4).

365. *See* Treas. Reg. § 1.401-1(b)(1)(ii)-(iii). A profit-sharing plan must provide a definite predetermined formula for allocating contributions among participants and for distributing the accumulated funds after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death or severance from employment. *Id.*

366. In the case of a profit-sharing or stock bonus plan, termination includes a complete discontinuance of contributions. *See* I.R.C. § 401(a)(20).

367. Rev. Rul. 71-224, 1971-1 C.B. 124.

368. A "fixed number of years" means at least two years. Rev. Rul. 71-295, 1971-2 C.B. 184. The two-year period runs from the actual date of contribution. *See* Rev. Rul. 73-553, 1973-2 C.B. 130. Eighteen months is deemed insufficient. *See* Rev. Rul. 71-295, 1971-2 C.B. 184. If money is transferred from one plan to another, the periods of accumulation under both plans are aggregated. *See* Priv.

Also, payments can be made to an alternate payee under a QDRO, even if none of the above events has occurred, if the QDRO and the plan so provide.[369]

C. *Elective Deferrals*

1. *Current Law.* Amounts attributable to elective deferrals under a 401(k) plan, and other contributions that are subjected to the same distribution restrictions (QMACs, QNECs, safe harbor 401(k) contributions) may only be distributed upon the occurrence of one of the following events (some of which are discussed in more detail below):[370] (1) death of the participant; (2) disability of the participant; (3) retirement; (4) separation from service;[371] (5) termination of the plan without establishment or maintenance of another defined contribution plan by the employer; (6) attainment of age fifty-nine and a half in the case of a profit-sharing or stock bonus plan; (7) hardship, in the case of elective contributions to a profit-sharing or stock bonus plan (this is not permitted under a safe harbor 401(k) plan);[372] (8) disposition *by a corporation* to an *unrelated*

Ltr. Rul. 83-35-083 (June 1, 1983); Priv. Ltr. Rul. 85-22-095 (Mar. 8, 1985); Priv. Ltr. Rul. 85-22-096 (Mar. 8, 1985); Priv. Ltr. Rul. 85-40-066 (July 9, 1985); Priv. Ltr. Rul. 88-18-050 (Feb. 12, 1988); Priv. Ltr. Rul. 88-25-130 (Mar. 31, 1988). If funds are rolled over, this starts a new period. *See* Priv. Ltr. Rul. 81-34-110 (May 28, 1981); Priv. Ltr. Rul. 81-49-044 (Sept. 9, 1981). A specified period, such as the completion of sixty months of plan participation, is also an event on the occurrence of which distributions can be made. Rev. Rul. 68-24, 1968-1 C.B. 150. Before 1987, an integrated profit-sharing plan could not allow in-service distributions. *See* Rev. Rul. 71-446, 1971-2 C.B. 187. This restriction apparently no longer applies. *See* Permitted Disparity With Respect to Benefits and Contributions, 53 Fed. Reg. 45917 (proposed Nov. 15, 1988) (as finalized at 26 C.F.R. pt. 1).

369. *See* I.R.C. § 414(p)(10); Treas. Reg. § 1.401-13(g)(3); *see also supra* note 363. Special restrictions apply if the plan has received a direct transfer of assets and liabilities from a money purchase pension plan; these restrictions do not apply to a rollover from a money purchase plan. *See* Rev. Rul. 94-76, 1994-2 C.B. 46.

370. *See* I.R.C. § 401(k)(2)(B)(i); Treas. Reg. § 1.401(k)-1(d).

371. *See* discussion *infra* Part IV.E.

372. *See* I.R.C. § 401(k)(2)(B)(i)(IV); *see also infra* Part IV.D. Hardship distributions and in-service distributions after age fifty-nine and a half may be made by a rural cooperative plan even though it is not a profit-sharing or stock bonus plan. I.R.C. § 401(k)(7)(C). For additional rules relating to hardship distributions, see Treas. Reg. § 1.401(k)-1(d)(2). The reduction of an employee's account balance derived from elective contributions, by reason of default on a loan from the plan, is treated as a distribution. Treas. Reg. § 1.401(k)-1(d)(6)(ii).

corporation of substantially all of the assets used by the corporation in a trade or business; and (9) disposition *by a corporation* to an *unrelated entity or individual* of its interest in a subsidiary.

With respect to event (5), termination of the plan—determined after application of sections 414(b), (c), (m) and (o)[373]—without establishment or maintenance of another defined contribution plan by the employer (other than an ESOP or SEP, the employer is determined as of the date of plan termination. Thus, in a stock sale, the termination should take place before the closing. The IRS has backed away from its prior position that distributions from the terminated plan must be completed before the closing of a corporate transaction. However, distributions should be completed as soon as possible.[374]

A plan is a successor plan only if it exists at any time during the period beginning on the date of plan termination and ending twelve months after distribution of all assets from the terminated plan. Also, a plan is not a successor plan if, throughout the twenty-four month period beginning twelve months before the termination, fewer than 2% of the employees who were eligible under the 401(k) plan are eligible under the other plan.[375] A partial termination is not enough.[376]

In an asset sale, the termination generally need not take place before the closing, because the seller and the buyer will never have been part of the same controlled group.

Event (8), disposition *by a corporation* to an *unrelated corporation* of substantially all (at least 85%)[377] of the assets used by the corporation in a trade or business, applies only (1) with respect to an employee who continues employment with the corporation acquiring the assets, (2) if the transferee corporation does not adopt the plan, or become

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This rule does not prohibit distribution by an ESOP of dividends described in I.R.C. § 404(k)(2). Treas. Reg. § 1.404(k)-1(d)(6)(iii).

373. *See* I.R.C. § 401(k)(10)(A)(i); Treas. Reg. § 1.401(k)-1(d)(3); *see also* Certain Cash or Deferred Arrangements and Employee and Matching Contributions Under Employee Plans, 59 Fed. Reg. 66,165, 66,166 (Dec. 23, 1994).

374. *See* Rev. Rul. 89-87, 1989-2 C.B. 81.

375. Treas. Reg. § 1.401(k)-1(d)(3); *see also* Priv. Ltr. Rul. 99-31-047 (May 10, 1999).

376. *See, e.g.*, Priv. Ltr. Rul. 95-23-025 (Mar. 13, 1995).

377. Treas. Reg. § 1.401(k)-1(d)(4)(iv).

an employer whose employees accrue benefits thereunder, and (3) if the plan is not merged or consolidated with, and assets or liabilities are not transferred to, a plan of the purchaser, in a transaction to which section 414(l) applies.[378]

This exception can be problematic. It does not apply if either the seller or the buyer is not a corporation. This would exclude many business entities, including the increasingly popular limited liability company (LLC), unless the LLC has elected to be taxed as a corporation.

What is a trade or business?[379] How does one determine which assets are used in a trade or business, and whether the assets disposed of are at least 85%? If less than 85% of the assets are disposed of, Revenue Ruling 2000-27[380] may be available.

Event (9), disposition *by a corporation* to an *unrelated entity or individual* of its interest in a subsidiary, applies only (1) with respect to an employee who continues employment with the subsidiary, (2) if the transferee does not adopt the plan, or become an employer whose employees accrue benefits thereunder, and (3) if the plan is not merged or consolidated with, and assets or liabilities are not transferred to, a plan of the purchaser, in a transaction to which section 414(l) applies.[381]

This exception can also be problematic. First, it does not apply if the seller is not a corporation. This would exclude many business entities, including the increasingly popular limited liability company (LLC), unless the LLC has elected to be taxed as a corporation. Second, the exception does not apply if the seller retains any of its prior interest in the subsidiary. Finally, the exception does not apply if the entity sold is related to the seller, but is not a subsidiary. Assume that a parent and its subsidiary each have separate

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378. *See* I.R.C. § 401(k)(10)(A)(ii), (k)(10)(C); Treas. Reg. § 1.401(k)-1(d)(1)(iv), (d)(4). The IRS ruled that a like-kind exchange under I.R.C. § 1031 qualified as a "disposition" for purposes of § 401(k)(10)(A)(ii). *See* Priv. Ltr. Rul. 99-25-045 (Mar. 31, 1999). Acceptance by the purchaser's plan of elective transfers or direct rollovers does not violate this requirement. *See* Treas. Reg. § 1.401(k)-1(d)(1)(iv), (d)(4).

379. *See* Priv. Ltr. Rul 00-36-048 (June 12, 2000); Priv. Ltr. Rul. 99-25-045 (Mar. 31, 1999); Priv. Ltr. Rul. 98-36-028 (June 9, 1998).

380. *See* discussion *infra* Part IV.E.

381. *See* I.R.C. § 401(k)(10)(A)(iii), (k)(10)(C); Treas. Reg. § 1.401(k)-1(d)(1)(v), (d)(4). Acceptance by the purchaser's plan of elective transfers or direct rollovers does not violate this requirement. *See id.*

401(k) plans. Some employees have worked for both companies, and have balances in each plan. If the parent sells the subsidiary, the sale is a distribution event for the parent's plan but not for the subsidiary's plan.

Under events (5), (8), and (9) above, the distribution must be a lump sum distribution[382] (and only a lump sum distribution) and must be made in connection with the disposition of assets or of the subsidiary. Except in unusual circumstances, this requirement will be satisfied only if the distribution is made by the end of the second calendar year after the calendar year in which the disposition occurred.[383]

A defined contribution plan that is not subject to the minimum funding rules, and that does not provide an annuity option, can be amended to provide that each participant will receive a lump sum on plan termination, without violating the anti-cutback rule.[384] However, this exception is not available if the employer maintains any other defined contribution plan (other than an ESOP) and, even under the new 411(d)(6) regulations, an annuity option may not be eliminated if the plan is required by statute to provide that option. Accordingly, for these plans the termination exception may not realistically be available.[385]

These limitations generally continue to apply even after amounts attributable to elective contributions are transferred to another qualified plan, but do not apply (1) to elective transfers[386], if the amounts could have been distributed (otherwise than for hardship) at the time of the transfer, or (2) to amounts directly rolled over to the 401(k) plan.[387]

Similar restrictions apply to the required employer contributions (matching or nonelective) to a safe harbor 401(k) plan, but in that case hardship distributions are not allowed.[388]

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382. Treas. Reg. § 1.401(k)-1(d)(5). For this purpose, for tax years beginning after 1999, this means a lump sum distribution as defined in I.R.C. § 402(e)(4)(D), without regard to subclauses (I) through (IV) of clause (i) thereof. I.R.C. § 401(k)(10)(B)(ii).

383. Treas. Reg. § 1.401(k)-1(d)(4)(iii).

384. *See id.* § 1.411(d)-4, A-2(b)(2)(vi).

385. *See id.* § 1.411(d)-4, A-3(b)(1)(i).

386. *See id.* § 1.411(d)-4, A-3(b)(1).

387. *Id.* § 1.401(k)-1(d)(6)(iv).

388. *See* I.R.C. § 401(k)(12)(E)(i).

Also, payments can be made to an alternate payee under a QDRO, even if none of the above events has occurred, if the QDRO and the plan so provide.[389]

2. *Recommendations.* It is absurd, time-consuming, and inefficient to have three separate sets of rules, and the complexity of the rules for elective deferrals is particularly troubling given the ever-increasing prevalence of 401(k) plans. It is understandable that Congress wished to restrict the ability of employees to use 401(k) deferrals as short-term savings arrangements, but I suggest that, rather than enacting special restrictions, the better approach would be to limit access to employees' interests in all types of tax-favored retirement arrangements, including IRAs and 403(b) plans. The ultimate goal is to preserve these funds for retirement, and thus the type of the plan and the source of the original contributions are unimportant by comparison. This issue is discussed further below.

D. *Hardship Distributions*

Under a 401(k) plan, hardship distribution of amounts attributable to an employee's elective deferrals is limited to the amount of his or her elective contributions, but may include investment income and amounts treated as elective contributions (qualified matching contributions and qualified nonelective contributions) which, in each case, were credited to the participant's account as of the later of a date (before January 1, 1989) specified in the plan or the last day of the last plan year ending before July 1, 1989.[390]

An employer which sponsors a 403(b) plan funded solely by employee deferrals will lose the regulatory ERISA exemption[391] if it has the right to approve hardship distributions.[392]

Withdrawal of funds for a current hardship undermines the goal of saving for retirement, and this problem is exacerbated by the rule that, following the hardship distribution, the participant may not make 401(k) deferrals

389. *See id.* § 414(p)(10); Treas. Reg. § 1.401(a)-13(g)(3); *see also supra* note 361 and accompanying text.

390. Treas. Reg. § 1.401(k)-1(d)(2)(ii).

391. *See* 29 C.F.R. § 2510.3-2(f) (as amended in 1982).

392. Dep't of Labor Advisory Opinion 94-30A, 1994 LEXIS 34, *8 (Aug. 19, 1994).

for a period of time.[393] However, the survey evidence indicates that the rate of savings is significantly higher under plans that allow hardship distributions and/or loans than under plans that do not. If, as thus appears likely, hardship distributions are a necessary evil, I suggest that (1) only the employee's deferrals should be distributable for hardship and (2) the rule requiring suspension of contributions should be repealed.

The rules for hardship distributions from a section 457 plan are more restrictive.[394]

E. *The Same Desk Rule*

Under prior law, one of the events that entitled an employee to favorable income tax treatment of a lump sum distribution was separation from service, and the same desk rule was originally developed to prevent individuals from claiming favorable tax treatment where there had not been a real separation. The basic principle is that, even if an individual's nominal employer has changed (for instance, as a result of a corporate acquisition), if the individual is doing the same job in the same place after the transaction, there is no separation from service.[395]

As the distribution restrictions for elective deferrals under a 401(k) plan use the same term, separation from service,[396] the IRS has also applied the same desk rule in testing whether an individual is eligible for a distribution of amounts attributable to such elective deferrals.

By contrast, "severance from employment" has been interpreted to allow pension distributions to an employee, provided that the employee's benefits were not held in or transferred to a plan maintained by the new employer:

> A determination as to whether a severance from employment has occurred should be made on the basis of whether or not the

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393. Treas. Reg. § 1.401(k)-1(d)(2)(iv)(B)(4).

394. Section 457 of the Code requires the participant to be faced with "an unforeseeable emergency." *See* Treas. Reg. § 1.457-2(h)(4). This is generally a factual determination, but does not include "the need to send a participant's child to college or the desire to purchase a home." *Id. But see* Treas. Reg. § 1.401(k)-1(d)(2) (applying hardship definitions to 401(k) plans).

395. *See, e.g.*, Reinhardt v. Comm'r., 85 T.C. 511 (1985); Rev. Rul. 81-26, 1981-1 C.B. 200; Rev. Rul. 79-336, 1979-2 C.B. 187; Priv. Ltr. Rul. 94-43-041 (Aug. 4, 1994).

396. I.R.C. § 401(k)(2)(B)(i)(I).

> employee continues to be employed by the employer maintaining the plan . . . rather than on the basis of whether the employee continues to work on the same job for a different employer as a result of a liquidation, merger, or consolidation, etc.[397]

This determination is made separately for each employee.[398]

In recent years, many commentators have pointed out that the same desk rule causes severe problems in connection with corporate transactions and, because the anti-cutback rule[399] often makes a plan merger or plan to plan transfer unattractive, actually causes assets to leave the retirement system rather than being preserved.[400]

In May 2000, apparently in response to these concerns, the IRS issued Revenue Ruling 2000-27.[401] In Revenue Ruling 2000-27, the employer sold less than substantially all of the assets of a trade or business to an unrelated employer. Most employees associated with the sold assets terminated employment with the seller and continued in the same jobs with the buyer. The IRS ruled that there had been a separation from service, so that benefits could be distributed from the seller's 401(k) plan. The ruling also provides that, for sales before September 1, 2000, IRS will not treat the plan as failing to meet its provisions merely because the employer does not treat the termination of employment from the seller and the hiring by the buyer as a separation from service and therefore does not permit distributions to the terminated employees.

At an informal meeting during an ABA Section of Taxation conference in May, 2000, IRS officials clarified the scope of Revenue Ruling 2000-27.[402]

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397. Gen. Couns. Mem. 39,824 (July 6, 1990).

398. *See* Rev. Rul. 56-693, 1956-2 C.B. 282 (modified by Rev. Rul. 60-323, 1960-2 C.B. 148). In Wulf v. Quantum Chem. Corp., 26 F.3d 1368 (6th Cir. 1994), the court brushed aside the same desk rule as a tax rule that was not relevant in interpreting ERISA. *See id.* at 1375; *see also* Kuper v. Iovenko, 66 F.3d 1447 (6th Cir. 1995) (distinguishing *Wulf* in holding that there was no termination of employment); Ronald R. Rizzo, *6th Circuit Opinion May Halt Plan Spinoffs and Mergers*, ERISA Litig. Rep., Aug. 1994, at 8.

399. I.R.C. § 411(d)(6); ERISA § 204(g), 29 U.S.C. § 1054(g) (1994). This rule is known to pension specialists as the "anti-cutback" rule.

400. *See, e.g.*, *Repeal Same Desk Rule ERISA Industry Committee Urges*, TAX NOTES TODAY, Apr. 19, 2000, *at* 2000 TNT 76-15.

401. Rev. Rul. 2000-27, 2000-1 C.B. 1016.

402. Bonner Menking, *ABA Tax Section: More Time and Flexibility for Amending Pension Plans*, TAX NOTES TODAY, May 15, 2000, *at* 2000 TNT 94-13.

First, the new ruling applies only to sales of less than 85% of the assets used in a trade or business. Second, the new ruling applies only if the seller does not transfer affected employees' account balances from its plan to a plan of the buyer, except as a result of a direct rollover elected by the employee. Third, employees of the seller must actually cease performing *any* services for the seller. Finally, the new ruling applies only to sales of assets, not to joint ventures or sales of stock.

Even after Revenue Ruling 2000-27, same desk issues still arise, for instance, if the employee continues to provide some services to the seller, or if there are plan to plan transfers: no transfers is one of the requirements for the Code section 401(k)(10) exceptions. By contrast, in the case of a pension plan, General Counsel Memorandum 39,824 applies the no transfer rule on a person by person basis.

Recent private rulings have been difficult to reconcile. Some have not allowed distributions,[403] while others have allowed distributions.[404]

If the same desk rule *does* apply, and the seller's plan provides, as it usually will, that an employee is entitled to a distribution on separation from service, the employee's separation from service will not occur until he or she terminates employment with the buyer, or perhaps is assigned to a different job.[405] What if there is a subsequent sale by the buyer: does the same desk rule apply again? How does the seller keep track of these subsequent events with which it has no connection? John Utz suggests the following:

> Because of the same desk rule, a seller continuing to maintain its 401(k) plan should include in its purchase agreement a covenant

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403. *See, e.g.*, Priv. Ltr. Rul. 2000-19-048 (Feb. 18, 2000); Priv. Ltr. Rul. 2000-27-059 (Apr. 11, 2000).

404. *See, e.g.*, Priv. Ltr. Rul. 2000-19-045 (Feb. 14, 2000); Priv Ltr. Rul. 2000-24-056 (Mar. 21, 2000); Priv. Ltr. Rul. 2000-30-031 (May 1, 2000); Priv. Ltr. Rul. 99-27-048 (Apr. 16, 1999); Priv. Ltr. Rul. 99-31-046 (May 10, 1999).

405. "The Journal understands, however, that in situations in which Section 401(k)10) does not apply, the IRS feels that if the same-desk rule applies at the time of the sale and an employee later changes his position but stays with the acquiring company, the same-desk rule would have the effect of preventing the employee from taking a distribution due to that change in job function. This apparently is the Service's position even if the new job function would have allowed a distribution had it occurred at the time of the acquisition." *New Developments in Legislation, Regulations and Informal Agency Positions*, 23 TAX MGMT. COMPENSATION PLAN. J. 195, 197 (1995).

> that the buyer will notify the seller when any of the seller's former employees terminate employment with the buyer. The seller may even want to require the buyer to impose a similar obligation on all subsequent purchasers.[406]

In view of these concerns, and the uncertainty of the present rules, Congress or the IRS should take speedy action to provide that, if termination of employment (in and of itself) continues to be an event that allows a plan to distribute benefits, then the same desk rule will no longer be applied in determining whether there has been a termination.

F. *Section 403(b) Plans*

Elective deferrals under a section 403(b) plan are subject to restrictions similar to those applicable to elective deferrals under a 401(k) plan, but there are fewer exceptions. Distributions attributable to salary reduction contributions may be paid only when the employee: (1) attains age fifty-nine and a half; (2) separates from service; (3) dies; (4) becomes disabled (as defined in section 72(m)(7)); or (5) has a hardship.[407]

In addition, if the 403(b) program is funded through a custodial account (rather than by the purchase of annuities), no amount (including amounts that are not attributable to salary reduction contributions) may be paid or made available before the employee: (1) dies; (2) attains age fifty-nine and a half; (3) separates from service; (4) becomes disabled (as defined in section 72(m)(7)); or (5) in the case of amounts contributed pursuant to a salary reduction agreement, encounters financial hardship.[408]

As noted above, I suggest that a single set of rules should apply to all retirement vehicles, so that there would no longer be special restrictions on funds derived from elective deferrals. In addition, there is no justification for

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406. JOHN L. UTZ, EMPLOYEE BENEFITS IN MERGERS AND ACQUISITIONS (ALI-ABA Course of Study Materials: Pension, Profit-Sharing, Welfare and Other Compensation Plans, 1999).

407. I.R.C. § 403(b)(11). These restrictions do not apply to assets that were in the plan on December 31, 1988, but do apply to post-1988 earnings on those amounts.

408. *Id.* § 403(b)(7)(A)(ii).

the special restrictions on custodial accounts, which should be repealed.

G. *SEPs and SIMPLE Plans*

Employer contributions to a SEP may not be conditioned on any portion of the contribution being kept in the account, and the employer may not prohibit withdrawals from the SEP.[409] This rule significantly undermines their effectiveness as retirement savings arrangements. I recommend that all IRAs, including SEPs and SIMPLE IRAs, should be subject to the same uniform distribution rules as will apply to other employer-sponsored plans.

H. *Loans to Participants*

In general, if the plan so provides, the plan may make loans to participants. Loans are not allowed from any type of IRA, including SEPs and SIMPLE IRAs. According to an Advisory Council report, by borrowing, a participant's retirement savings are reduced by 5.5% if the participant continues to make contributions during the repayment period, and by 27% if the participant suspends contributions during that period.[410]

In order to avoid the loan being treated as a taxable distribution of benefits to the borrowing participant, the loan (1) must satisfy the Code's limitations on the amount and duration of the loan,[411] and (2) must satisfy the requirements for exemption from the prohibited transaction rules.[412] A loan may not be made to an owner-employee, namely a more than 10% owner of a partnership or limited liability company or a more than 5% shareholder of an S

409. *See id.* § 408(k)(4).

410. ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFITS PLANS, WORKING GROUP ON RETIREMENT PLAN LEAKAGE, U.S. DEP'T OF LABOR, ARE WE CASHING OUT OUR FUTURE? 16 (1998) [hereinafter ADVISORY COUNCIL REPORT].

411. *See* I.R.C. § 72(p).

412. *See* ERISA § 408(b)(1), 29 U.S.C. § 1108(b)(1) (1994 & Supp. II 1996). The DOL regulations have detailed requirements for the contents and communication of a written plan loan program. *See* 29 C.F.R. § 2550.408b-1(d) (1989).

corporation.[413] If an S election is made with respect to a corporation that was previously a C corporation, any outstanding loan to a more than 5% shareholder becomes a prohibited transaction by virtue of the election.[414] An outstanding loan may be transferred to another plan, but not to an IRA.[415]

Borrowing from a retirement plan may undermine the goal of saving for retirement, though the obligation to repay the loan makes loans preferable to hardship distributions from this point of view. Loans can reduce an employee's ultimate retirement savings in two ways. First, the rate of interest on the loan (which is credited to the borrower's account) is generally less than the rate of return on other plan investments. Second, the need to repay the loan may require the borrower to contribute less than he or she would otherwise have done.

However, the survey evidence indicates that the rate of savings is significantly higher under plans that allow hardship distributions and/or loans than under plans that do not. If, as thus appears likely, loans are a necessary evil, I suggest that only the employee's deferrals should be available for a loan. The prohibition against IRA loans should be retained, as the lack of uniformity in this area is less troubling than the extension of loans to IRAs.

I. *Conclusion and Recommendations*

There is little, if any, justification for continuing to have different rules for different types of individual account plans. I suggest that, consistent with the recommendations relating to the premature distribution penalty tax,[416] distributions before a certain age (such as fifty-five) from any type of plan should be strictly limited. After that age, distributions from any type of individual account plan should be available, if the plan so provides.[417]

If the present value of the participant's benefit under a plan exceeds $5000, the benefit may not be distributed,

413. I.R.C § 4975(f)(6); ERISA § 408(d)(2), 29 U.S.C. § 1108(d)(2) (1994 & Supp. III 1997).

414. Rev. Rul. 84-44, 1984-1 C.B. 105 (1984).

415. *See* Treas. Reg. § 1.401(a)(31)-1, A-16 (as amended in 2000); *see also* Treas. Reg. § 1.402(c)-2, A-9; Priv. Ltr. Rul. 96-17-046 (Jan. 31, 1996).

416. *See infra* Part VII.B.

417. *See, e.g.*, Pratt & Bennett, *supra* note 41, at 5-22.

prior to the later of age sixty-two or normal retirement age, without the participant's consent.[418] If the value of the benefit does not exceed $5000, the benefit may be distributed without the participant's consent, and without complying with the annuity rules (if they would otherwise be applicable).[419] This rule sends the (wrong) message that these relatively small distributions are not worth bothering about. For many low income employees, the best they can expect from the pension system may be a series of small payouts each time they change jobs. For instance, if a thirty year old employee receives a $5000 cashout and earns a 9% annual return, it will be worth $80,000 by the time he or she reaches age sixty-two. According to one database cited in the Advisory Council report, only 20% of distributions under $3500 were rolled over in 1996, compared to 95% of distributions over $100,000. Also, the rollover rate was 89% for individuals aged sixty or older, but only 26% for those in their twenties.[420]

From a policy perspective, it is hard to justify loans and hardship distributions, as both undermine the important policy goal of preserving tax-favored retirement savings for retirement rather than using them for current consumption. However, prohibiting loans and hardship distributions could discourage employees, particularly lower-paid employees, from making elective deferrals. According to the Advisory Council report,[421] the average employee participation rate in plans that allow loans is 61%, compared to 55% for plans that do not. For plans that provide a matching contribution, the increase is from 78% to 83%. In addition, average employee contributions are 35% higher under plans that allow loans than under plans that do not.[422] Plan loan features are popular with employees.[423] The Advisory Council report also indicates that employee participation rates are higher in plans that

418. I.R.C. § 411(a)(11); ERISA § 203(e), 29 U.S.C. § 1053(e); Treas. Reg. § 1.411(a)-11(c)(4).

419. I.R.C. § 417(e); ERISA § 205(g), 29 U.S.C. §1055(g).

420. ADVISORY COUNCIL REPORT, *supra* note 410, at 8 (citing the 1996 Hewitt database).

421. *See* ADVISORY COUNCIL REPORT, *supra* note 410 (citing a GAO report).

422. *See id.* at 39-40. The Report also concluded that "[l]oans and hardship withdrawals are necessary safety valves to a long-term savings objective." *Id.*

423. DIANNE BENNETT ET AL., TAXATION OF DISTRIBUTIONS FROM QUALIFIED PLANS 8-22 (Warren et al. eds., 2d ed. 2000).

allow hardship withdrawals (76%) than in plans that do not (68%).[424]

V. THE MINIMUM DISTRIBUTION RULES

Numerous authors have described in detail the mind-boggling complexities of these rules, and have recommended simplification.[425] Finally, the IRS and Treasury have responded, by issuing new proposed regulations that do, in fact, simplify the rules significantly.[426]

Designed to force plan participants and IRA owners to start receiving their retirement benefits during retirement, rather than leaving the funds to accumulate on a tax-deferred basis,[427] they have conspicuously failed to do so, and this failure is not addressed in the new regulations.[428] An entire cottage industry has emerged, consisting of advising wealthy clients how to stretch out distributions over the longest possible period, by designating very young family members or trusts as beneficiaries.

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424. *See* ADVISORY COUNCIL REPORT, *supra* note 410.

425. See, for instance, Warshawsky, *Minimum Distribution Requirements: Reform or Remove Them*, TAX NOTES TODAY, Sept. 30, 1998, at 1133 (describing the rules as "increasingly outmoded in today's labor market and social conditions"); Pratt & Bennett, *supra* note 41, at 5-14 to 5-17 (recommending that no minimum distributions be required during the lifetime of the plan participant (or IRA owner) and, if he or she is the beneficiary, the surviving spouse, but that the entire benefit should be fully distributed on the death of the survivor of them); Jay A. Soled & Bruce A. Wolk, *The Minimum Distribution Rules and Their Critical Role in Controlling the Floodgates of Qualified Plan Wealth*, 2000 B.Y.U. L. REV. 587, 617, 619 (2000) (recommending that joint life expectancy should be used only if the designated beneficiary is the spouse and that accounts must be distributed within the year following the participant's (and spouse's) death).

426. 66 Fed. Reg. 3928 (Jan. 17, 2001).

427. "Uniform minimum distribution rules which establish the permissible periods over which benefits from any tax-favored retirement arrangement may be distributed ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income stream at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan." JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 710 (1987).

428. For instance, assume that a decedent names her five year old grandson as the designated beneficiary of her IRA, which is worth $1 million at her death. The current rules allow the IRA to be paid out over the grandchild's life expectancy, 76.6 years. With an 8% annual return, the total payments, if the grandchild takes only the required minimum each year, would be more than $800 million. This is patently absurd.

The minimum distribution rules apply to qualified plans, 403(b) plans, and IRAs (including SEPs and SIMPLE IRAs).[429] Similar rules which are, for no apparent reason, different in several respects, apply to eligible deferred compensation plans under section 457(b).[430] The statute leaves most of the details to be provided in regulations: lengthy and complex proposed regulations were issued in 1987, but they were never finalized. One hopes that the new proposed regulations will be finalized promptly. One major concern has been that the manner in which IRS has apparently been interpreting the 1987 proposed regulations is, in several important respects, either not suggested by those regulations or inconsistent with the text of the regulations.[431]

However, the most pernicious aspect of the rules is that they apply even to very small retirement benefits, are replete with traps for the unwary,[432] and carry a confiscatory penalty for failure to withdraw the required amount: an excise tax equal to 50% of the shortfall.[433]

In the case of a qualified plan, the minimum required distribution must be taken separately from each plan. In the case of an IRA or 403(b) plan, the required minimum must be calculated separately for each plan or account, but the total may then be taken from any one or more of them.[434]

Under a 403(b) plan, the current minimum distribution rules apply only to contributions made, and investment earnings credited, after December 31, 1986, provided that the plan has records of the pre-1987 accumulation. The pre-1987 accumulation is subject to the old rules.[435]

429. I.R.C. §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b). The minimum distribution rules do not apply to a Roth IRA during the lifetime of the IRA owner and, if he or she is the beneficiary, the owner's surviving spouse. *See id.* § 408A(c)(5).

430. *Id.* § 457(d)(2).

431. *See, e.g.*, Noel C. Ice, *Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Area: From the Sublime to the Ridiculous*, 25 ACTEC NOTES 226 (1999).

432. *See, e.g.*, Lynn Asinof, *Oops. . .How a Variety of Basic Foul-Ups Are Bedeviling the Beneficiaries of IRAs*, WALL ST. J., Mar. 29, 1999, at C1.

433. *See generally* I.R.C. § 4974 (applying to qualified plans, 403(b) plans, IRAs and 457(b) plans).

434. I.R.S. Notice 88-38, 1988-1 C.B. 524.

435. Prop. Treas. Reg. § 1.401(a)(9)-2, 66 Fed. Reg. 3928 (Jan. 17, 2001); *see also* Priv. Ltr. Rul. 93-45-044 (Nov. 12, 1993) (suggesting that the old rules will be satisfied if distributions begin at age seventy-five). This grandfather

VI. SURVIVOR ANNUITY BENEFITS

A. *The Basic Rules*

Qualified retirement plans further a policy of protecting the rights of spouses by requiring that pension plans (defined benefit, money purchase or target benefit plans) provide (1) a qualified joint and survivor annuity (QJSA) as the required form of benefit, unless the participant, with the informed written consent of the spouse, elects otherwise; and (2) a qualified pre-retirement survivor annuity (QPSA) for the surviving spouse in the event of the death of a vested participant prior to beginning to receive payments, unless the spouse elects otherwise.[436]

For an unmarried participant, the normal form of benefit is a life annuity unless the participant elects to receive a different form of distribution.[437]

Tax-sheltered annuity arrangements described in Code section 403(b) are not subject to the Code rules, but are (if they are subject to ERISA) subject to the corresponding ERISA rules.[438]

Even plans that are not automatically subject to the annuity rules (such as 401(k) plans, profit-sharing plans and ESOPs) will be required to comply unless they provide that, on the death of a married participant, the entire account balance will be paid to the surviving spouse, unless properly waived by such spouse.[439]

Thus, the consent of the spouse will be required (1) for a non-spouse beneficiary designation of death benefits and (2) in the case of a pension plan, for retirement distributions in a form other than a QJSA. These requirements have not been changed by the new regulations under Code section 411(d)(6).

Any plan that is required to offer the QJSA and QPSA is also required to give the participant a written explanation of the annuity option, including the terms and conditions of the annuity, the participant's right to make,

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treatment is lost if the 403(b) plan benefit is rolled over to an IRA. *See* Prop. Treas. Reg. § 1.403(b)-2 (2001).

436. *See generally* I.R.C. §§ 401(a)(11)(ii), 417; ERISA § 205, 29 U.S.C. §1055(a)(2) (1994 & Supp. III 1997).

437. Treas. Reg. § 1.401(a)-20, A-25(a) (as amended in 2000).

438. *See* ERISA § 205, 29 U.S.C. §1055(b)(2)(B).

439. *See* I.R.C. § 401(a)(11)(B)(iii).

and the effect of, an election to waive the annuity, the spousal consent rules, and the participant's right to make, and the effect of, a revocation of an election to waive the annuity.[440]

A consent to a beneficiary designation (as to the form of the benefit and/or the beneficiary) may be made specific as to the chosen designation or may be a blanket consent (in which case it would allow subsequent changes in the beneficiary designation).[441] The designation of a trust which benefits the surviving spouse requires the waiver and consent procedures to be followed.

None of these rules applies to IRAs. Thus, regular IRAs, SEPs, SIMPLE IRAs and Roth IRAs are all exempt from these requirements. Also, the rules do not apply to governmental plans,[442] church plans,[443] or most nonqualified deferred compensation arrangements, including deferred compensation plans of governmental or tax-exempt employers which are described in Code section 457.[444]

A spouse who waives the right to a survivor annuity is giving up potentially valuable rights. If the spouse signs a waiver without legal advice, can the validity of the waiver be challenged? In addition, an attorney who represents both husband and wife must be sensitive to the ethical considerations.

The spouse's consent to waive his or her right to a QJSA or QPSA must (1) acknowledge the effect of the election and (2) be witnessed by a plan representative or a

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440. I.R.C. § 417(a)(3); ERISA § 205(c)(3), 29 U.S.C. § 1055(c)(3) (1994).

441. *See* I.R.S. Notice 97-10, 1997-1 C.B. 370 (containing sample spousal consent language).

442. I.R.C. §§ 401(a)(9)(c)(iv), 411(e)(1)(A); ERISA § 4(b)(1), 29 U.S.C. § 1003(b)(1) (1994 & Supp. II 1996); I.R.C. § 414(d), 29 U.S.C. § 1002(32) (defining "governmental plan").

443. I.R.C. §§ 401(a)(9)(C)(iv), 411(e)(1)(B); ERISA § 4(b)(2), 29 U.S.C. § 1003(b)(2); I.R.C. § 414(e), 29 U.S.C. § 1002(33) (defining "church plan").

444. A nonqualified plan, by definition, is one which does not attempt to satisfy the requirements of section 401(a) of the Code. Any excess benefit plan (as defined in section 3(36) of ERISA, 29 U.S.C. §1002(36)), and any unfunded plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees are exempt from the requirements of section 205 of ERISA. ERISA § 201(2), (7), 29 U.S.C. § 1051(2), (7) (1994).

notary public.[445] In one recent case, a consent without a witness' signature was held to be invalid.[446]

B. *Qualified Joint and Survivor Annuity*

1. *In General.* Under a QJSA, periodic payments must be made to the married participant for life. Periodic payments must continue to the participant's spouse (if he or she survives the participant) and must be between 50% and 100% of the participant's lifetime benefit.[447]

A defined benefit plan may satisfy this requirement by making the distributions directly out of the plan trust, or by purchasing an annuity contract. A defined contribution plan will purchase an annuity.

In general, under a defined benefit plan, the QJSA will be actuarially equivalent in value to the normal form of benefit, typically a single life annuity, provided by the plan, though sometimes the plan will subsidize the QJSA. Under a defined contribution plan, the amount of each monthly payment will be the amount that can be purchased with the participant's vested account balance.

2. *Selection of an Alternative Form of Benefit.* First, the plan must permit an alternative form of benefit, such as a lump sum or other form of installment distribution. Second, proper notice of all of the forms of benefit must be provided to the participant.[448] Third, if a different form of benefit is to be selected, and the participant is married, not only must the participant select the different form in writing but also the participant's spouse must consent in writing to that different form.[449] In general, all of this must take place between thirty and ninety days prior to the date payments will begin, although the thirty day minimum notice period

445. I.R.C. § 417(a)(2)(A)(i).

446. *See* Lasche v. George W. Lasche Basic Profit Sharing Plan, 11 F.3d 863, 864 (11th Cir. 1997).

447. I.R.C. § 417(b); ERISA § 205(d), 29 U.S.C. § 1055(d).

448. *See* I.R.C. § 417(a)(3); ERISA § 205(c)(3), 29 U.S.C. § 1055(c)(3).

449. I.R.C. § 417(a)(2)(A); ERISA § 205(c)(2), 29 U.S.C. § 1055(c)(2). The plan may provide that the annuity rules do not apply until the participant and spouse have been married for a year. *See* I.R.C. § 417(d)(1); ERISA § 205(f), 29 U.S.C. § 1055(f).

may be waived.[450] Accordingly, a spousal waiver included in a pre-nuptial agreement is ineffective.[451]

C. *Qualified Preretirement Survivor Annuity*

1. *In General.* Pension plans are also required to provide, as a mandatory form of pre-retirement death benefit, an annuity to the surviving spouse of a vested participant who dies before beginning to receive plan benefits.[452] This annuity, payable for the spouse's life, is generally required to be actuarially equivalent to the survivor's annuity that would have been payable to the spouse under a QJSA.[453] Accordingly, the amount is essentially the actuarial equivalent of 50% of the participant's vested benefit, converted to the form of a lifetime annuity. Under a defined contribution plan, the amount of the QPSA is the amount that can be purchased with 50% of the participant's vested account balance.[454]

2. *Selection of Alternative Form of Death Benefit.* Again, an alternative form of death benefit can only be selected if it is available under the plan and is affirmatively elected by the participant or, if the plan so provides, by the surviving spouse after the participant's death.[455] If the participant is married or later marries, the new form of death benefit is payable only if the spouse consents to the different form. As with the waiver of a QJSA, there are notification requirements that must be satisfied both as to content and as to timing.[456]

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450. I.R.C. § 417(a)(6)-(7); ERISA § 205(c)(6)-(7), 29 U.S.C. § 1055(c)(6)(A), (8)(B) (1994 & Supp. II 1996). Also, the spouse can generally waive the right to a QPSA, or to receive the entire account balance, under a plan that is not subject to the survivor annuity rules, at any time after the marriage. *See* Treas. Reg. § 1.401(a)-20, A-33(a) (as amended in 2000).

451. The prevailing view is that a premarital waiver of the QJSA (for instance, in a prenuptial agreement) is void. *See* Hurwitz v. Sher, 982 F.2d 778 (2d Cir. 1992); Treas. Reg. § 1.401(a)-20, A-28. However, the Sixth Circuit has held that a premarital waiver may be valid. *See* Callahan v. Hutsell, No. 92-5796, 1993 U.S. App. LEXIS 34005, at *3 (6th Cir. Dec. 20, 1993).

452. I.R.C. § 401(a)(11)(A)(ii); ERISA § 205(a)(2), 29 U.S.C. § 1055(a)(2) (1994).

453. I.R.C. § 417(c)(1)(A); ERISA § 205(e)(1)(A), 29 U.S.C. § 1055(e)(1)(A).

454. I.R.C. § 417(c)(2); ERISA § 205(e)(2), 29 U.S.C. § 1055(e)(2).

455. I.R.C. § 417(a); ERISA § 205(c); 29 U.S.C. § 1055(c).

456. I.R.C. § 417(a)(3); ERISA § 205(c)(3)(A); 29 U.S.C. § 1055(c)(3)(A).

A spouse's consent to a beneficiary designation by the participant (as to the form of the benefit and/or the beneficiary) may be made specific to the chosen designation or may be a blanket consent (in which case it would allow subsequent changes in the beneficiary designation).[457] The designation of a trust which benefits the surviving spouse requires the waiver and consent procedures to be followed.

D. *Affected Plans*

The QJSA and QPSA requirements apply to (1) all defined benefit plans and (2) any defined contribution plan that is subject to the minimum funding requirements, namely money purchase pension plans and target benefit pension plans.[458] These requirements do not apply to (1) a tax credit ESOP described in Code section 409(a), with respect to the portion of the participant's account balance that is subject to the requirements of section 409(h); (2) an ESOP described in Code section 4975(e)(7), with respect to the portion of the participant's account balance that is subject to the requirements of section 409(h);[459] or (3) a defined contribution plan which is not subject to the minimum funding requirements (i.e., a profit-sharing or stock bonus plan).

The QJSA and QSPA requirements do not apply under the above three circumstances, provided that, in each case, on the death of the participant, the entire vested account balance (reduced by any outstanding balance on a loan from the plan) is payable to the surviving spouse or, if there is no surviving spouse, or the surviving spouse consents, to a designated beneficiary. Additionally, the participant must not elect to receive payment in the form of a life annuity, and, with respect to that participant, (1) the plan is not a direct or indirect transferee, in a transfer after December 31, 1984, of a plan that was subject to the annuity requirements with respect to that participant, and (2) the

457. Treas. Reg. § 1.401(a)-20, A-31(a)-(c) (as amended in 2000).

458. I.R.C. § 401(a)(11)(B)(ii); ERISA § 205(b)(1)(B), 29 U.S.C. 1055(b)(1)(B).

459. For purposes of determining the extent to which Code section 401(a)(11) applies to benefits under an ESOP, as defined in section 4975(e)(7) of the Code, the portion of the benefit subject to Code section 409(h) is treated as though it were provided under a defined contribution plan that is not subject to section 412 of the Code. Treas. Reg. § 1.401(a)-20, A-3(c).

benefits under the plan do not offset benefits under such a transferee plan.[460]

IRAs are not subject to the annuity rules, but plans subject to ERISA section 205, such as non-governmental 403(b) plans, are subject to the requirements to the same extent as qualified plans.[461]

If the plan is subject to the annuity rules, spousal consent must be obtained for a loan if the accrued benefit is to be used as security.[462]

E. *Recommendations*

The annuity rules[463] are very difficult and costly for plan sponsors. In addition, it is almost impossible, in many cases, to explain effectively to employees what their choices are, and for plan participants and their spouses to decide, with any confidence, what form of distribution is best for them. Almost all defined contribution plans, and many defined benefit plans, allow participants to choose a lump sum distribution, and the survey evidence shows clearly that, where a lump sum is available, only a very small percentage of plan participants will choose to receive an annuity. There must be some spouses who receive a benefit because of the rules, and who would not receive any benefit otherwise. However, experience and the available evidence suggest that they are very few in number,[464] and that this result simply does not justify the enormous expense and complexity that the rules create.[465]

Accordingly I recommend that, as a first step, the law be changed so that defined contribution pension plans can avoid being subject to the QJSA and QPSA rules by complying with the conditions applicable to profit-sharing and stock bonus plans.[466] The participant's spouse would still be protected by the requirement that he or she must be

460. I.R.C. § 401(a)(11)(B)-(C); ERISA § 205(b)(1)-(2), 29 U.S.C. § 1105(b)(1), (2); Treas. Reg. § 1.401(a)-20.

461. *See* Treas. Reg. §1.401(a)-20, A-3(d).

462. Treas. Reg. § 1.401(a)-20, A-24.

463. *See generally* I.R.C. §§ 401(a)(11), 417; ERISA § 205, 29 U.S.C. § 1055.

464. "Several empirical studies show that, unless [the spouses'] property is large enough to entail tax planning, spouses overwhelmingly strain to leave everything to the surviving spouse, commonly disinheriting children in the process." LANGBEIN & WOLK, *supra* note 343, at 584.

465. Pratt & Bennett, *supra* note 41, at 5-28.

466. For a more detailed discussion, see *supra* Part VI.D.

the beneficiary of 100% of the participant's benefits under the plan, unless he or she consents to another beneficiary being named.

In addition, it is anomalous, given the increasing utilization of rollover IRAs, that spouses are protected with respect to benefits under qualified plans and 403(b) plans, but have no protection once the benefits are rolled over to an IRA. Surely the nature and extent of spousal protection should be the same, regardless of the type of retirement arrangement involved. Accordingly, though it does not further simplification, consideration should be give to making IRAs subject to the same (modified) rules as apply to defined contribution plans.

VII. INCOME TAXATION OF RETIREMENT PLAN DISTRIBUTIONS[467]

A. *General Rules*

With Dianne Bennett, I have written elsewhere about the need to simplify the appalling hodge-podge of rules governing the taxation of retirement plan distributions.[468] Accordingly, I will address the topic only briefly in this article.

The general rule is that the full amount of each payment, from any type of plan (including an IRA) will be taxable unless the employee has basis.[469] Generally, the individual will have basis only if (1) after-tax employee contributions were made or (2) the plan provided life insurance protection. Deductible contributions made by the individual (to an IRA, 401(k) plan, or 403(b) plan) do not result in basis.

For years after 1999, the special tax treatment for "lump sum distributions"[470] has generally been repealed, but

467. *See generally* I.R.C. §§ 72, 402. For a more comprehensive treatment of tax issues, see BENNETT ET AL., *supra* note 423.

468. *See generally* Pratt & Bennett, *supra* note 41.

469. There are special rules that apply to Roth IRAs. *See generally* I.R.C. § 408A.

470. A "lump sum distribution" is a distribution from a qualified plan made within one taxable year of the recipient, which represents the balance to the credit of the employee and is payable (i) on account of the employee's death; (ii) on or after the employee attains age fifty-nine and a half; (iii) on account of separation from service for an employee; or (iv) on account of disability for a self-employed individual. *See* I.R.C. § 402(e)(4)(D). For further discussion on

transition rules are still in effect for the taxation of lump sum distributions:[471] (1) if the participant was born before 1936, ten year averaging may be elected; and (2) if the participant was born before 1936, and plan participation commenced before 1974, a portion of the lump sum distribution is eligible for long term capital gains treatment at a 20% rate.

If an employee receives a distribution of employer securities, there are special rules for the taxation of the "net unrealized appreciation," namely the value of the securities minus their cost basis to the plan.[472]

B. *The Premature Distribution Penalty*

The primary purpose of the tax subsidy for qualified plans is to encourage individuals to save for their retirement. An important aspect of this policy is to attempt to ensure that funds contributed to a retirement plan continue to be held in a retirement plan until the individual retires, rather than being used for current consumption.[473]

Code §72(t) imposes a penalty tax on most distributions made before the date on which the employee or account owner attains age fifty nine and a half, from any qualified plan, 403(b) arrangement or IRA. The tax is equal to 10% of the amount includible in income, so does not apply to the portion of any distribution that is not taxable, for instance because it is rolled over or represents a return of basis.[474]

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distributions payable on account of separation from service, see *supra* Part IV.E.

471. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1401(c)(2), 110 Stat. 1755, 1789 (1996); *see also* I.R.S. Announcement 87-2, 1987-12 I.R.B. 38, Q & A C4.

472. *See generally* I.R.C. § 402(e)(4).

473. This issue is discussed in detail in the Advisory Council Report, which states that "[t]he statistics, however, show that most Americans spend their retirement savings far in advance of retirement. The most recent Current Population Survey determined that only 20 percent of individuals who received lump sum distributions rolled the entire sum into another tax-qualified vehicle. Leakage from retirement plans is a serious threat. Popular notions of the dangers of participant loans and hardship withdrawals are overstated. The real culprit is the temptation to spend lump sum distributions, particularly smaller distributions and distributions made at an early age." ADVISORY COUNCIL REPORT, *supra* note 410, at 3.

474. The rate of tax is 25% for withdrawals from a SIMPLE IRA within the two year period beginning on the date the employee first participated in the SIMPLE IRA. I.R.C. § 72(t)(6). In addition, a withdrawal of a salary reduction

Recent legislation has added yet more exceptions to the tax, so there are now fifteen separate statutory exceptions.[475]

Of these exceptions, six apply to distributions from any type of plan;[476] three apply *only* to distributions from an IRA;[477] one applies only to ESOPs;[478] and the final five do *not* apply to IRA distributions.[479]

In practice, the exception for substantially equal periodic payments[480] allows wealthy taxpayers, with careful planning, to receive distributions beginning at almost any age, without exposure to the penalty tax. The larger the account balance, the greater the flexibility, as IRAs can be divided and subdivided almost at will.

There are serious questions as to whether a 10% penalty is sufficient to deter premature withdrawals.[481] The second major problem with the tax is the numerous exceptions, most of which make little or no sense from a policy perspective.

I recommend the following changes.[482] First, the only exceptions should be those for death and disability.

Second, age fifty-nine and a half should be changed to age fifty-five, a common earliest early retirement age, age sixty or age sixty-two, which is currently the earliest age at which one can receive Social Security retirement benefits.

SEP contribution is subject to a separate 10% penalty tax if it is made before the employer determines whether the applicable nondiscrimination test has been satisfied. *See id.* §§ 72(t)(1), 408(d)(7).

475. For a more detailed discussion, see Pratt & Bennett, *supra* note 41, at 5-17 to 5-23. In addition, the tax does not apply to the taxable cost of current life insurance protection (the PS 58 cost). *See* I.R.S. Notice 89-25, 1989-1 C.B. 662, A-11.

476. I.R.C. §§ 72(t)(2)(A)(ii)-(iv), (vii), 72(t)(2)(B), 402(g)(2)(C).

477. *Id.* § 72(t)(2)(D)-(F).

478. *Id.* § 72(t)(2)(A)(vi).

479. *Id.* §§ 72(t)(3)(A), 72(t)(2)(A)(v), 72(t)(2)(C), 401(k)(8)(D), 401(m)(7)(A); Tax Reform Act of 1986 (1986), Pub. L. No. 99-514, § 1123(e)(4), as amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1011A(c)(12) (1988); I.R.S. Notice 83-23, 1983-2 C.B. 418.

480. I.R.C. § 72(t)(2)(A)(iv); *see also* I.R.S. Notice 89-25, 1989-1 C.B. 662, A-12.

481. *See generally* Susan E. Anderson, *Is the Penalty Tax for Premature Individual Retirement Account Withdrawals Regressive?*, TAX NOTES TODAY, July 28, 1995, *at* 95 TNT 147-81 (concluding that the tax is regressive); Angela E. Chang, *Tax Policy, Lump-Sum Pension Distributions, and Household Savings*, 49 NAT'L TAX J. 235 (1996) (explaining the ineffectiveness of the penalty in raising rollovers for recipients with low incomes).

482. These recommendations follow the recommendations made by Pratt and Bennett. *See* Pratt & Bennett, *supra* note 41, at 5-20.

Third, a 10% tax is clearly not sufficient to deter premature withdrawals, and spending, of retirement savings.[483] One approach would be to increase the tax significantly, but this would disproportionately affect lower income plan participants, including some who have immediate needs for which they use the money.[484]

A better approach is to significantly limit, or eliminate, the right to receive withdrawals from a qualified plan or 403(b) plan before a certain age, by requiring a direct rollover, to an IRA or another qualified plan, of all distributions other than annuity payments.[485] A more radical change would extend this requirement to IRAs. The penalty for noncompliance would be a substantial penalty tax.

C. *Rollovers*

An "eligible rollover distribution" may be rolled over, tax-free.[486] A distribution from a qualified plan may be rolled over to an IRA or another qualified plan;[487] a distribution from a 403(b) plan may be rolled over to an IRA or to another 403(b) plan;[488] an IRA distribution may be rolled over to another IRA or, if the IRA includes only amounts previously rolled over from a qualified plan or 403(b) plan, and investment earnings thereon (a conduit IRA), to another qualified plan or 403(b) plan, as the case may be.[489]

I suggest the following simplifications to the rollover rules.[490] First, allow rollovers of any actual distributions

483. The 1993 Current Population Survey determined that only 20% of the individuals who received lump sum distributions rolled the entire amount into another tax favored retirement plan. Forty percent more rolled over part of the distribution. ADVISORY COUNCIL REPORT, *supra* note 410, at 8; *see also* Chang, *supra* note 481.

484. *See* Anderson, *supra* note 481.

485. The Advisory Council Report recommends that, subject to a hardship exception, all lump sums in excess of $2000 be required to be rolled over. ADVISORY COUNCIL REPORT, *supra* note 410, at 5.

486. *See* I.R.C. § 402(c).

487. *See id.* § 402(c)(1), (c)(8)(B).

488. *See id.* § 403(b)(8).

489. *See id.* § 408(d)(3). A special rule applies to distributions from a SIMPLE IRA and no distribution from an inherited IRA may be rolled over. *Id.* § 408(d)(3)(C), (d)(3)(G).

490. Again, these recommendations were previously made by Pratt and Bennett. *See* Pratt & Bennett, *supra* note 41, at 5-39 to 5-40.

(including annuity payments and after-tax employee contributions, but excluding corrective distributions and required minimum distributions) from qualified plans and 403(b) plans.

Second, amounts distributed by qualified plans, 403(b) plans and IRAs (other than Roth IRAs) should be eligible for rollover to any such plan that accepts rollovers.[491]

Third, eliminate the one rollover per year rule for IRAs[492] and the rule that does not permit the cash equivalent of distributed property to be rolled over,[493] so that if a qualified plan distributed property that cannot be held by an IRA (such as S corporation stock, life insurance or a collectible), the property need not be sold.

D. *Additional Recommendations*

The rules governing the taxation of distributions from qualified plans, 403(b) plans and IRAs are now largely uniform, and the few remaining differences should be eliminated.

Another possible route to simplification would be to eliminate, or severely restrict, after-tax contributions.

The original premise for favorable tax treatment of lump sum distributions and net unrealized appreciation on employer securities was to avoid bunching of income. That premise has not been valid since rollovers were introduced in 1974.[494] These special rules have no continuing justification and should be repealed completely.

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491. This proposal was included in the Portman-Cardin bill introduced on March 11, 1999. *See* H.R. 1102, 106th Cong. (1999). That bill also would have allowed rollovers from and to 457 plans. *See id.*

492. I.R.C. § 408(d)(3).

493. I.R.C. § 402(c)(1)(C), (c)(6); Rev. Rul. 87-88, 1987-33 I.R.B. 6.

494. This point is made in The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (Treasury II) (1985), at 345.

VIII. PLANS THAT INVEST IN EMPLOYER SECURITIES[495]

A. *Introduction*

When it enacted ERISA in 1974, Congress was concerned about plans that held excessive investments in employer securities. Accordingly, ERISA generally prohibits plans from holding any employer security[496] which is not a "qualifying employer security" and holding employer securities whose value exceeds 10% of the value of plan assets.[497] However, subject to a special rule[498] for certain elective deferrals, which is of limited applicability, neither of these rules applies to an "eligible individual account plan."[499] In addition, an eligible individual account plan is exempted from the general diversification requirements[500] with respect to its holding of qualifying employer securities.[501]

Many of the special rules relating to employer securities are in section 409 of the Code (which was originally enacted, as section 409A, by the Revenue Act of 1978)[502] to

495. *See generally* ADVISORY COUNCIL ON EMPLOYEE WELFARE AND PENSION BENEFITS PLANS, U.S. DEP'T OF LABOR, REPORT OF THE WORKING GROUP ON EMPLOYER ASSETS IN ERISA EMPLOYER-SPONSORED PLANS 12 (1997), *at* http://www.dol.gov/dol/pwba/public/adcoun/acemer.htm ("According to the KPMG survey, approximately 90% of all company stock is held by plans of companies with more than 5,000 employees. Smaller plans have significantly lower concentrations of company stock."). The Working Group Report concluded that there is a significant investment by defined contribution plans in company stock. *Id.* The investment affects the retirement income and security of millions of plan participants and is worthy of serious attention by the Department of Labor. *Id.* The report also noted that executive benefits under nonqualified plans, as unsecured debt, have priority in bankruptcy over company stock held by a qualified defined contribution plan. *Id.*

496. An employer security is a security issued by an employer of employees covered by the plan, or by an affiliate of such an employer. ERISA § 407(d)(1), 29 U.S.C. § 1107(d)(1) (1994).

497. ERISA § 407(a)(1)-(2), 29 U.S.C. § 1107(a)(1)-(2). There are similar restrictions with respect to employer real property. *See* ERISA §§ 407(a)(3)-(4), 414(c), 29 U.S.C. §§ 1107(a)(3)-(4), 1114(c) (containing transition rules).

498. *See* ERISA § 407(b)(2), 29 U.S.C. § 1107(b)(2) (Supp. III 1997).

499. *See* ERISA § 407(b)(1), 29 U.S.C. § 1107(b)(1) (1994).

500. ERISA § 404(a)(1)(C), (a)(2), 29 U.S.C. § 1104(a)(1)(c), (a)(2).

501. ERISA § 407(b)(3)(A), 29 U.S.C. § 1107(b)(3)(A) (1994 & Supp. III 1997). Also, in the case of an eligible individual account plan, the prudence requirement (to the extent that it requires diversification) is not violated by acquisition or holding of qualifying employer securities. ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2) (1994).

502. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763.

set forth the additional requirements that had to be satisfied in order for the employer to be able to claim tax credits for certain ESOP contributions.[503] These credits were repealed by the Tax Reform Act of 1986, but section 409 was not repealed. Its provisions now apply to (1) ESOPs with respect to which credits were claimed under the prior law and (2) other plans to which individual requirements of section 409 have been extended by subsequent legislation.

B. *What Is a "Qualifying Employer Security"?*

Under ERISA, an employer security is a security issued by an employer of employees covered by the plan, or by an affiliate (as defined in § 407(d)(7)) of such an employer.[504] The term "qualifying employer security" means an employer security which is (1) stock; (2) a marketable obligation, as defined in section 407(e); or (3) an interest in a publicly traded partnership.

After December 17, 1987, in the case of a plan that is not an eligible individual account plan, an employer security described in (1) or (3) will be a qualifying employer security only if it satisfies additional requirements.[505] First, immediately following the acquisition of the stock or partnership interest, no more than 25% of the issued and outstanding stock of that class may be held by the plan. Second, at least 50% of the issued and outstanding stock must be held by persons independent of the issuer.[506]

By contrast, for purposes of Code section 409, "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) which is readily tradable on an established securities market.[507] If there is no such common stock, then "employer securities" means common stock issued by the employer (or by a corporation which is a member of the same controlled group) having a combination of voting power and dividend rights at least equal to the class of common stock having the greatest voting rights and the

503. These credits were enacted by section 301(d) of the Tax Reduction Act of 1975 and the Economic Recovery Tax Act of 1981.

504. ERISA § 407(d)(1), 29 U.S.C. § 1107(d)(1).

505. ERISA § 407(d)(5), 29 U.S.C. § 1107(d)(5).

506. ERISA § 407(f)(1)(B), 29 U.S.C. § 1107(f)(1)(B).

507. I.R.C. § 409(l)(1).

class of common stock having the greatest dividend rights.[508]

Noncallable preferred stock will be treated as employer securities if it is convertible at any time into common stock described above and the conversion is at a price which, as of the date of acquisition by the plan, is reasonable.[509]

C. *What Is an "Eligible Individual Account Plan"?*

The term "eligible individual account plan" means a plan that explicitly provides for the acquisition and holding of qualifying employer securities, and includes (1) a profit-sharing, stock bonus, ESOP, thrift or savings plan, and (2) a money purchase pension plan, but only if the plan invested primarily in qualifying employer securities on September 2, 1974.

The term does not include an IRA, or any defined contribution plan whose benefits are taken into account in determining the benefits payable to any participant under any defined benefit plan.[510]

A 401(k) plan is an eligible individual account plan and may, if the plan so provides, invest up to 100% of its assets in employer stock, Thus, for instance, as of September 30, 2000, 81% of Coca-Cola's 401(k) plan assets was invested in company stock, which employees are not allowed to sell until they reach age fifty-three.[511]

> In addition to Coca-Cola, consider the recent fortunes (last year through December 8, 2000) of Lucent Technologies, with 48% of its 401(k) assets in Lucent stock, which had lost 77.6% of its value; AT&T, with 28% of its plan assets in company stock, and its share price down by 59.8%; Tenneco Automotive, with 35% of its plan assets in company stock, and its share price down by 65.4%; Cooper Tire & Rubber with 56% of its plan assets in company stock, and its stock price down by 37%; and JCPenney with 48% of its plan assets in company stock and the price down by 56%.

508. *Id.* § 409(l)(2).

509. *Id.* § 409(l)(3). The term "controlled group of corporations" is defined in section 409(l)(4)(A) of the Code.

510. *See* ERISA § 407(d)(3), 29 U.S.C. § 1107(d)(3). An arrangement which consists of a defined benefit plan and an individual account plan will be treated as one plan if the benefits of the individual account plan are taken into account in determining the benefits payable under the defined benefit plan. ERISA § 407(d)(9), 29 U.S.C. § 1107(d)(9).

511. Jinny St. Goar, *Gimme Shelter*, PLAN SPONSOR MAGAZINE (Jan. 2001), *available at* http://www.plansponsor.com/content/magazine/GimmeShelter.

Finally McKesson HBOC, with 72% of its plan in company stock, saw its stock price down by 71% in 1999, only to rebound by 47% in 2000.[512]

One recent survey found that, in 401(k) plans which offered company stock as an investment option, the average asset allocation to company stock was 36.3% of the account (23.9% if the plan also offered a guaranteed investment contract option).[513]

D. *Special Rules for Plans That Hold Employer Securities*

The complexity of the rules is exacerbated by the fact that different rules apply to different groups of plan.[514]

1. *Rules Applicable Only to ESOPs As Defined in Section 4975(e)(7).* Most of the special ESOP rules are made specifically applicable to ESOPs, as defined in section 4975(e)(7).[515] The special deduction limit for leveraged ESOPs[516] and non-recognition of capital gain on certain sales to an ESOP[517] apply only to ESOPs. The same is true of the exemption from the excise tax on reversions (for assets transferred to an ESOP between April 1, 1985 and December 31, 1988),[518] and the 50% exclusion from gross income for interest received on an ESOP loan, and the related exemption from the rules for taxation of below-market-interest loans, which rules now apply only to loans made before August 21, 1996, and certain refinancings of such loans.[519]

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512. *Id.*

513. Sarah Holden & Jack VanDerhei, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 1999, in* INVESTMENT COMPANY INSTITUTE PERSPECTIVE (Jan. 2001), at 10 fig.8, *available at* http://www.ici.org/pdf/per07-01.pdf; *see also* Daniel Kadlec, *Time Bomb*, TIME, May 15, 2001, *at* http://www.time.com; Justin Martin, *Quieting the Concerns of Nervous Workers*, FORTUNE, Oct. 12, 1998.

514. For a summary of the rules applicable to each type of plan, *see infra* Appendix D.

515. *See* I.R.C. § 4975(e)(7) (describing the requirements that must be satisfied for the ESOP to qualify for the special ESOP exceptions from the prohibited transaction rules).

516. *See id.* § 404(a)(9).

517. *See id.* § 1042(a), (b).

518. *Id.* § 4980(c)(3)(E).

519. *See* I.R.C. §§ 133, 7872(f)(12) (repealed Aug. 20, 1996).

Additionally, the excise taxes for early disposition of, and for violating the non-allocation rules under section 409(n) relating to, stock acquired by the ESOP in a transaction subject to section 1042 are applicable only to ESOPs.[520] No portion of the assets of an ESOP attributable to (or allocable in lieu of) employer securities acquired by the plan in a sale to which section 1042 (non-recognition of capital gain by the seller to the ESOP) applies may accrue (or be allocated, directly or indirectly, under any qualified plan of the employer) for the benefit of (1) any person who elects to defer recognition of gain under section 1042, (2) individuals related to that person, or (3) certain other individuals who are actual or constructive shareholders of the corporation, or of another corporation which is a member of the same controlled group.[521]

2. *Rules Also Applicable to Tax Credit ESOPs.* The following rules apply both to section 4975(e)(7) ESOPs and to tax credit ESOPs.[522] First, the joint and survivor annuity requirements do not apply to that portion of the benefit under an ESOP that is subject to section 409(h).[523]

Second, in order to comply with the diversification requirement,[524] the plan must allow each "qualified participant" to elect, within ninety days after the close of each plan year in the "qualified election period", to direct the plan as to the investment of at least 25% of his or her account, to the extent that such portion exceeds the amount to which any prior election applies.[525] In the case of the final election year, 50% is substituted for 25%. The plan can meet this requirement in either of the following ways: (1) by

520. *See id.* §§ 4978, 4979A.

521. *See id.* § 409(n)(1).

522. Certain rules apply only to tax credit ESOPs, including a special employee coverage rule under § 410(b)(6)(D), an allocation rule under § 409(b), a vesting rule under § 409(c), and a seven year retention rule under § 409(d). *See* I.R.C. §§ 409(b)-(d), 410(b)(6)(D). Other rules that apply only to tax credit ESOPs deal with the time of establishment of the plan, reimbursement of the employer's expenses in establishing the plan, recovery of contributions conditioned on plan qualification and non-recognition of gain on the transfer of securities to the plan. I.R.C. § 409(f), (i), (j), (m).

523. *See id.* § 401(a)(11)(C). The requirements of § 401(a)(11)(B)(iii)(I)-(III) must be satisfied.

524. *See id.* § 401(a)(28)(B).

525. *See id.* § 401(a)(28)(B)(i); *see also* I.R.S. Notice 88-56, 1988-1 C.B. 540, A-9.

distributing the portion subject to the election, within ninety days after the period during which the election may be made;[526] or (2) by offering at least three investment options to each participant who elects to diversify and, within ninety days after the period during which the election may be made, the plan invests the portion of the account covered by the election in accordance with the election.[527]

A "qualified participant" is any employee who has completed at least ten years of participation in the plan and has attained age fifty-five.[528] The "qualified election period" means the six plan year period beginning with the first plan year in which the individual first became a qualified participant.[529]

Third, the requirement that all valuations of employer securities which are not readily tradable on an established securities market, with respect to activities carried on by the plan, must be performed by an independent appraiser.[530] Fourth, the deduction for certain dividends paid on employer securities held by the ESOP.[531]

Finally, the exemption from certain requirements of the anti-cutback rule also applies to tax credit ESOPs.[532] The plan does not violate section 411(d)(6) merely because it modifies distribution options in a nondiscriminatory manner.[533] Also, the plan may be amended to provide that a distribution is not available in employer securities to the extent that an employee has elected to diversify pursuant to section 401(a)(28).[534]

3. *Rules That Also Apply to Non-ESOPs.* Finally, certain provisions are made applicable to plans that are not ESOPs at all. Thus, the following rules must be satisfied by

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526. I.R.C. § 401(a)(28)(B)(ii)(I).

527. *Id.* § 401(a)(28)(B)(ii)(II).

528. *Id.* § 401(a)(28)(B)(iii).

529. *Id.* § 401(a)(28)(B)(iv).

530. *Id.* § 401(a)(28)(C). The appraiser must meet requirements similar to those prescribed for valuations of property donated to charity.

531. *See id.* § 404(k).

532. I.R.C. § 411(d)(6)(C); ERISA § 204(g)(3), 29 U.S.C. § 1054(g)(3) (1994).

533. I.R.C. § 411(d)(6)(C); ERISA § 204(g)(3), 29 U.S.C. § 1054(g)(3).

534. Treas. Reg. § 1.411(d)-4, A-2(b)(2)(iv) (as amended in 2000). Additional exceptions are provided for ESOPs, tax credit ESOPs, and stock bonus plans. Treas. Reg. § 1.411(d)-4.

any section 4975(e)(7) ESOP or tax credit ESOP, and also by the other specified types of plan:

a. *Voting Rights.*[535] This requirement applies to an ESOP if the ESOP has a registration-type class of securities, and to a stock bonus or money purchase plan if more than 10% of its assets are employer securities and the plan is established by an employer whose stock is not readily tradable on an established market.[536]

If the employer has a registration-type class of securities, participants and beneficiaries must be entitled to direct the voting of the employer securities allocated to their accounts. If the employer does not have a registration-type class of securities, participants and beneficiaries must be entitled to direct the voting of the employer securities allocated to their accounts, but only with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business or any similar transaction prescribed by regulation.[537]

b. *The Right to Receive Benefits in the Form of Employer Securities.*[538] A stock bonus plan must satisfy the requirements of section 409(h) and (o). In applying section 409(h) for this purpose, the term "employer securities" includes any employer securities held by the plan.[539]

In the following cases, the plan need not give participants the right to demand a distribution of employer securities: (1) the employer's charter or by-laws restrict the ownership of substantially all outstanding employer securities to employees or to a qualified trust; (2) the employer is an S corporation; (3) the employer is a bank which is prohibited by law from redeeming or purchasing its own securities; or (4) to the extent that the employee has elected to diversify the investment of his or her account under section 401(a)(28).[540]

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535. *See* I.R.C. § 409(e).
536. *See id.* § 401(a)(22).
537. *Id.* § 409(e)(3).
538. *Id.* § 409(h).
539. *Id.* § 401(a)(23).
540. *Id.* § 409(h)(2)-(3), (7).

c. *A Put Option with Respect to Unmarketable Securities.*[541] If employer securities distributed to a participant are not readily tradable on an established securities market, the participant has the right to require that the employer repurchase employer securities under a fair valuation formula.[542] This put option is exercisable during either of two sixty-day periods, and the statute specifies how and when the purchase price is to be paid.[543]

A stock bonus plan must satisfy these requirements. In applying section 409(h) for this purpose, the term "employer securities" includes any employer securities held by the plan.[544]

d. *The Accelerated Distribution Rules*[545] *and the Requirements for Payment of the Price When the Employer Honors the Put Option.*[546] This rule also applies to a defined contribution plan that is neither an ESOP nor a profit-sharing plan, in which case the put option applies to all employer securities held by the plan, not only to employer securities as defined in section 409(l).

Subject to any required consent from the participant and his or her spouse, the plan must provide that distribution of the participant's benefits will commence not later than one year after the close of the plan year (1) in which the participant separates from service by reason of the attainment of normal retirement age, disability or death, or (2) which is the fifth plan year following the plan year in which the participant otherwise separates from service, provided that he or she is not re-employed before distributions are required to commence.[547]

For purposes of this rule, a participant's account balance will not include any employer securities acquired with the proceeds of a loan, until the close of the plan year in which the loan is repaid in full.[548]

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541. I.R.C. § 409(h).

542. *Id.* § 409(h)(1)(B); Treas. Reg. § 54.4975-7(b)(10), 7(b)(12) (1977). For rulings on the meaning of "readily tradable," see Priv. Ltr. Rul. 00-52-014 (Dec. 29, 2000), Priv. Ltr. Rul. 95-29-043 (July 21, 1995).

543. I.R.C. § 409(h)(4)-(6).

544. *Id.* § 401(a)(23).

545. *See id.* §§ 401(a)(23), 409(o).

546. *See id.* §§ 401(a)(23), 409(h)(5)-(6).

547. *Id.* § 409(o)(1)(A).

548. *Id.* § 409(o)(1)(B).

In addition, unless the participant elects otherwise, distribution of the account must be made in substantially equal payments over a period not longer than five years.[549] If the account exceeds $500,000, the plan is allowed an extra year for each $100,000 (or fraction thereof) by which the balance exceeds $500,000.[550]

CONCLUSION

The preceding sections of this article illustrate the complexity of the rules governing defined contribution plans. This complexity is exacerbated by the numerous differences between the rules applicable to different types of plans, many of which serve no useful purpose. Simplification of these rules, and elimination of these unnecessary differences, is important for two major reasons. First, to ease the severe compliance burden for current plan sponsors. Second, to make retirement plans more attractive to those employers that do not currently sponsor a plan.

POSTSCRIPT

After this article was written Congress, with consummate timing, finally enacted legislation—the Economic Growth Tax Relief Reconciliation Act (the "Act")—that makes substantial changes to the rules discussed above.[551] It is impossible to discuss all of the relevant changes. The following are the changes most pertinent to the theme of this article: simplification of the rules for defined contribution plans.

A. *Changes That Promote Simplification*

The limitations on employer deductions have been rationalized under the Act. First, elective deferrals by employees will no longer count toward the maximum.[552] Second, all qualified defined contribution plans (profit-

549. *Id.* § 409(o)(1)(c).

550. *Id.* § 409(o)(1)(C)(ii). The $500,000 and $100,000 amounts are indexed for cost of living increases.

551. *See* Economic Growth Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, Title VI (2001) (enacted June 7, 2001).

552. *Id.* § 614 (adding I.R.C. § 404(n)).

sharing, money purchase or target benefit) will now be subject to the same maximum.[553]

The rules governing top-heavy plans have also been simplified.[554] Additionally, the maximum exclusion allowance (MEA), a very complicated calculation that applied only to tax-sheltered annuity plans under Code section 403(b), has been repealed.[555] The special higher limits that applied to certain participants in 403(b) plans have also been repealed.[556]

The Act provides that no hardship distributions will be eligible to be rolled over.[557] Previously, certain hardship distributions were eligible, but others were not.

The Act allows rollovers between qualified plans, 403(b) plans, IRAs, and governmental 457 plans, and allows a surviving spouse to make a rollover to any type of eligible retirement plan, not only an IRA.[558] Subject to certain conditions, the Act also permits rollovers of after-tax employee contributions.[559]

The Act eliminates some of the differences between the distribution restrictions for different types of defined contribution plan, and repeals the "same desk" rule.[560] The Act also provides that 457 plans will be subject to the same minimum distribution rules (at age seventy and a half) that apply to other plans, and repeals the additional rules that previously applied to 457 plans.[561] Finally, the Act repeals the multiple use test for 401(k) plans.[562]

B. *Changes That Add Complexity*

For taxable years after 2005, the Act provides that Roth contributions (non-deductible when made, and generally not taxable when distributed) can be made to a 401(k) or 403(b) plan.[563] The Act also allows additional catch-up

553. *Id.* § 616 (amending I.R.C. § 404(a)).
554. *Id.* § 613 (amending I.R.C. § 416).
555. *Id.* § 632.
556. *Id.* § 632(a)(3)(E) (repealing I.R.C. § 415(c)(4)).
557. *Id.* § 636(b).
558. *Id.* § 641.
559. *Id.* § 643(a)-(b) (amending I.R.C. §§ 401(a)(31), 402(c)(2)).
560. *Id.* § 646(a) (amending I.R.C. §§ 401(k)(2)(B)(i)(I), 403(b)(7)(A)(ii), 403(b)(11)(A), 457(d)(1)(A)).
561. *Id.* § 649(a) (amending I.R.C. § 457(d)(2)).
562. *Id.* § 666(a) (amending I.R.C. § 401(m)(9)).
563. *Id.* § 617 (adding I.R.C. § 402A).

contributions, under any plan which accepts employee deferrals, for plan participants who are fifty years of age or older at the end of the year.[564]

Under a tax-sheltered annuity (403(b)) plan, the participant's "compensation," for purposes of the limitations under Code section 415, will be his or her "includible compensation" as defined under Code section 403(b)(3), which differs significantly from the compensation used by other plans in applying these limitations.[565]

The Act also requires faster vesting of matching contributions made for plan years beginning after 2001.[566] This means that different vesting requirements will apply to (1) matching contributions made for years beginning after 2001 and (2) matching contributions made for earlier years and other employer contributions.

Finally, the Act introduces exceptionally complex new rules for ESOPs sponsored by S corporations,[567] and new disclosure requirements where a pension plan amendment significantly reduces future benefit accruals.[568]

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564. *Id.* § 631 (adding I.R.C. § 414(v)).

565. *Id.* § 632(a)(3)(D) (amending I.R.C. § 415(c)(3)).

566. *Id.* § 633 (amending I.R.C. § 411(a) and ERISA § 203(a), 29 U.S.C. § 1053 (a) (1994)).

567. *Id.* § 656(a)(c)(1) (adding new I.R.C. § 409(p) and amending I.R.C. § 4979A).

568. *Id.* § 659(a)(1) (adding I.R.C. § 4980F).

Appendix A

COMPARISON OF A SEP AND QUALIFIED PROFIT-SHARING PLAN

Employee Coverage

The SEP must cover all employees (including part-time and seasonal employees) who have attained age twenty-one, performed service for the employer during at least three of the last five years, and received at least $300 (indexed—the 2001 threshold is $450) from the employer for the year.[569]

The profit-sharing plan need only satisfy the ratio percentage test or average benefit test under section 410(b). This allows at least 30% of those non-highly compensated employees (NHCEs) who have satisfied the plan's eligibility requirements to be excluded, for any reason.

Contributions and Allocations

Under the profit-sharing plan, contributions must be "substantial and recurring." This requirement does not apply to a SEP.

Under the SEP, an eligible employee must receive an allocation, even if he or she terminates employment before the end of the year.

Under the profit-sharing plan, the plan may generally require an employee to have at least 1000 hours of service during the year *and* still be employed at the end of the year as preconditions of receiving an allocation. This may not be possible under a small plan.

The nondiscrimination rules for SEPs are much more restrictive than the section 401(a)(4) rules applicable to profit-sharing plans, which permit, for example, cross-testing and restructuring.

569. Certain union employees and non-resident aliens may be excluded. *See* I.R.C. § 408(k)(2).

Establishing the Plan

The profit-sharing plan must be established by the last day of the employer's taxable year in order for the employer to be allowed a deduction for that year.

The SEP can be set up after the end of the year, provided that it is established by the due date (without extensions) of the employer's federal income tax return.[570]

The Trustee

The SEP must use a corporate trustee or custodian. The profit-sharing plan may have individuals (for example, officers of the employer) as trustees.

Distributions

Under the SEP, the employer may not restrict the employee's ability to withdraw funds at any time. Under the profit-sharing plan, permissible distribution events are limited by the Code and regulations, and the employer is not required to allow distributions at all of the permissible times, for example, the employer need not allow in-service distributions.

Vesting

An employee's SEP account must be fully vested at all times. The profit-sharing plan may include a vesting schedule.

Investments and Prohibited Transactions

The SEP is subject to the investment restrictions that apply to all IRAs (for example, no life insurance and no loans to the participant).

A SEP investment in collectibles has adverse tax consequences (the same is true for a participant-directed account under the profit-sharing plan).

A SEP must limit investment in qualifying employer securities and qualifying employer real property to 10% of

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570. *See id.* § 404(h)(1); *see also* Susan Foreman Jordan, *The Hidden Dangers in the Use of SEPs*, 19 TAX MGMT. COMPENSATION PLAN. J. 9 (1991).

its assets. A profit-sharing plan is an "eligible individual account plan" which can, if the plan so permits, and subject to ERISA fiduciary rules, invest up to 100% of its assets therein.

If the SEP engages in a prohibited transaction (PT), the entire value of the account is immediately taxable. If the profit-sharing plan engages in a PT, there is a first tier excise tax equal to 15% of the "amount involved". If the PT is not corrected, there is a second tier excise tax equal to 100% of the amount involved.

Spousal Rights

A SEP is not subject to the qualified joint and survivor (QJSA) or qualified preretirement survivor annuity (QPSA) rules, regardless of who the SEP beneficiary is. A profit-sharing plan can escape these rules only if the participant's spouse receives 100% of the account balance on the participant's death, or consents to another beneficiary.

Income Tax Withholding

A SEP distribution that is not rolled over is not subject to mandatory 20% income tax withholding.

Elective Deferrals

The nondiscrimination test for elective deferrals under a salary reduction SEP (SARSEP) is more restrictive than the actual deferral percentage (ADP) test under a 401(k) plan, and no new SARSEP can be set up after 1996.[571]

A profit-sharing plan may also allow after-tax employee contributions, but a SEP may not.

Employer Deduction

The SEP deduction rules are somewhat less generous than those for profit-sharing plans.

571. For instance, at least 50% of the eligible employees under a SARSEP must elect to make salary reduction contributions, and the deferral percentage of each HCE may not be more than 125% of the ADP for all eligible NHCEs. *See* I.R.C. § 408(k)(6). Even before 1997, SARSEPs were only available to small employers. I.R.C. § 408(k)(6)(B).

Administrative Issues

A SEP is very easy and inexpensive to establish, as most vendors simply use an IRS form, Form 5305-SEP or Form 5305A-SEP. However, the model SEP is not available to several categories of employers, including an employer that currently maintains any other qualified plan or that has ever maintained a defined benefit plan.[572]

If certain requirements are satisfied, no annual reports (Form 5500) need be filed and no summary plan description (SPD) prepared.[573]

SEPs are rarely, if ever, audited by the IRS or the DOL. However, the SEP rules are not always easy to apply and, because a pension professional is rarely involved, mistakes frequently occur and are not often corrected. There is no formal IRS correction program for SEPs, though the IRS is accepting submissions.

Creditor Protection

SEPs may have more or less protection against claims of the employee's creditors. This is a matter of state law.[574]

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572. Rev. Proc. 87-50, 1987-2 C.B. 647.

573. *See* 29 C.F.R. §§ 2520.104-48, 2520.104-49 (1980); *see also* I.R.S. Notice 81-1, 1981-1 C.B. 610.

574. The Investment Company Institute has prepared a helpful chart showing the extent of the protection enjoyed by each type of IRA under the laws of each state. *See* INVESTMENT COMPANY INSTITUTE, 1999 INSTITUTE STATE SURVEY OF IRA PROTECTION IN BANKRUPTCY (1999), *at* http://www.ici.org/retirment/99_state-ira-bnkrptrcy.html; *see also* Mark P. Altieri & Richard A. Naegele, *Creditors' Rights, Tax-Qualified Plans and IRAs*, 26 J. PENSION PLAN. & COMPLIANCE 13, 23-30 exhibit 1 (2001).

Appendix B

COMPARISON OF A QUALIFIED PROFIT-SHARING PLAN AND A QUALIFIED MONEY PURCHASE PLAN

Contributions and Allocations

Under the profit-sharing plan, contributions must be "substantial and recurring." This requirement does not apply to a money purchase plan. However, the employer must make the contributions required by the money purchase formula in order to comply with the minimum funding rules, which do not apply to a profit-sharing plan.

Contributions to a profit-sharing plan can be completely discretionary. Money purchase plans are subject to the "definitely determinable" requirement, which means that the employer may not have discretion as to how much to contribute.

A transfer of property to a money purchase plan, to satisfy the employer's funding obligation, is a prohibited transaction. A transfer of property to a profit-sharing plan is only a prohibited transaction if it satisfies an enforceable obligation of the employer to contribute.

Distributions

Under the profit-sharing plan, there is a broad range of permissible distribution events under the Code and regulations, including in-service distributions. The rules relating to elective deferrals under a 401(k) plan are more restrictive. Under the money purchase plan, in-service distributions are prohibited before normal retirement age or plan termination.

Investments and Prohibited Transactions

A money purchase plan (unless it is part of an ESOP) must generally limit investment in qualifying employer securities and qualifying employer real property to 10% of its assets. A profit-sharing plan is an "eligible individual account plan" which can, if the plan so permits, and subject to ERISA fiduciary rules, invest up to 100% of its assets therein.[575]

Spousal Rights

A money purchase plan is always subject to the qualified joint and survivor (QJSA) and qualified preretirement survivor annuity (QPSA) rules.[576] A profit-sharing plan can escape these rules if the participant's spouse receives 100% of the account balance on the participant's death, or consents to another beneficiary.

Elective Deferrals

The profit-sharing plan can include a qualified cash or deferred arrangement (CODA), allowing employees to make pre-tax elective deferrals. A money purchase plan cannot include a qualified CODA unless it is a rural cooperative plan or it accepted employee deferrals on June 27, 1974.

Employer Deduction

The effective limit on deductible contributions to a money purchase plan is 25% of the total taxable compensation of all employees who benefit under the plan. For a profit-sharing plan, the limit is 15% of compensation: employee deferrals count toward the maximum and are not included in the compensation base.

Incidental Benefits

The limits on the amount of life insurance that can be purchased are different for money purchase plans than for profit-sharing plans.

A profit-sharing plan may, and a money purchase plan may not, provide accident and health insurance for active employees. By contrast, the money purchase plan may, and the profit-sharing plan may not, provide health insurance for retirees.

575. *See* ERISA § 407(d)(3)(A), (e), 29 U.S.C. § 1107(d)(3)(A), (e) (1994).
576. *See* I.R.C. §§ 401(a)(11)(B), 417; ERISA § 205(b), 29 U.S.C. § 1055(b).

Appendix C

MAJOR CHARACTERISTICS OF PLANS THAT ALLOW PRE-TAX ELECTIVE DEFERRALS BY EMPLOYEES[577]

This appendix profiles the characteristics of 401(k), Safe Harbor 401(k), SIMPLE 401(k), 403(b), 457(b) and SIMPLE IRA plans.[578]

Employer Eligibility

A 401(k) plan, safe harbor 401(k) plan, 403(b) plan or 457(b) plan may be adopted by an employer of any size. However, there are a number of exceptions. First, the Tax Reform Act of 1986, as amended, generally precludes the adoption of a new 401(k) plan by any State or local government or political subdivision thereof, or any agency or instrumentality thereof.[579]

Second, a 403(b) plan may be adopted only by an employer that is (1) tax-exempt under Code section 501(c)(3) (an organization that is exempt under any other subsection of section 501(c) does not qualify) or (2) a public educational organization or (3) a minister of religion described in Code section 414(e)(5)(A).[580]

Third, a section 457(b) plan may be adopted only by a public employer or by a private tax-exempt employer (this includes organizations exempt under sections other than section 501(c)), other than a church.[581] Churches and for-profit employers may instead adopt a nonqualified deferred

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577. *See generally* Michael Footer et al., *Tax-Deferred Annuities v. § 401(k) Plans—The Choice Is Yours*, 24 TAX MGMT. COMPENSATION PLAN. J. 249 (1996) (examining the key features of tax-deferred annuities and § 401(k) plans); *see also* CAROL V. CALHOUN & DANNY MILLER, CHOOSING AMONG 401(K), 403(B) AND 457 PLANS, *available at* http://www.benefitsattorney.com.

578. This Appendix does not discuss (1) SARSEPs, as no new SARSEPs can be established after 1996, or (2) trusts under section 501(c)(18) of the Code, because these trusts are rare.

579. *See* I.R.C. § 401(k)(4)(B). This prohibition does not apply to a rural cooperative plan, or to a plan of an Indian tribal government. I.R.C. § 401(k)(4)(B)(iii), 401(k)(7). There is a grandfather rule for plans adopted before May 6, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1116(f) (1986).

580. *See* I.R.C. § 403(b)(1).

581. *See id.* § 457(b)(1), (e)(1).

compensation plan, which can generally be much more flexible than a 457(b) plan.

A SIMPLE IRA or SIMPLE 401(k) plan may be adopted only by an employer which, for the preceding year, had no more than 100 employees who earned at least $5000 from the employer.[582] However, there is a grace period for previously eligible employers that exceed this limit.[583]

Employee Coverage

As a qualified plan, any 401(k) plan, safe harbor 401(k) plan or SIMPLE 401(k) plan may exclude employees who (1) have not yet satisfied the plan's minimum age and service eligibility requirements or (2) are within another statutory exclusion (e.g., union employees). In addition, the plan may exclude at least 30% of the non-excludable NHCEs for any reason.[584]

A SIMPLE plan is generally required to be available to every employee who has earned at least $5000 from the employer in any two prior years, and is reasonably expected to earn at least $5000 during the current year.[585]

With respect to contributions not made pursuant to a salary reduction agreement, a 403(b) plan maintained by a private employer (other than a church) must satisfy the coverage rules as if it were a qualified plan.[586]

With respect to contributions made pursuant to a salary reduction agreement, a 403(b) plan maintained by an employer other than a church must generally allow all employees to make elective deferrals, without imposing any waiting period.[587]

A 457(b) plan maintained by a governmental employer is not subject to any employee coverage requirements.[588] A 457(b) plan maintained by a private tax-exempt employer is

582. *Id.* § 408(p)(2)(C)(i). The employer aggregation rules of Code section 414 apply in determining whether the employer satisfies this requirement. *See* I.R.C. § 414(b), (c), (m)(4)(B).

583. *See id.* § 408(p)(2)(C)(ii), (p)(10).

584. *Id.* § 410(b)(1)(A); *see also supra* Part III.A.1.

585. I.R.C. § 408(p)(4). Employees described in Code section 410(b)(3) may be excluded. The $5000 figure is not indexed for cost of living increases.

586. *See id.* § 403(b)(12)(A)(i).

587. *See id.* § 403(b)(12)(A)(ii). For a discussion of exceptions, see *supra* Part III.A.1.

588. *See* I.R.C. § 457(b). Also, unlike the other plans, a 457(b) plan may cover service providers who are not employees. *See id.* § 457(b)(1), (e)(2).

required to limit participation to a select group of management or highly compensated employees, in order to avoid an irreconcilable conflict between the requirements of ERISA and the requirements of section 457(b).

Employer Aggregation

In determining whether retirement plans and other employee benefits qualify for tax-favored treatment under the Code, the employer aggregation rules[589] generally require related employers to be treated as a single employer. These employer aggregation rules apply to all types of 401(k) plan and also to SIMPLE IRAs, but do not apply to 457 plans.[590]

The employer aggregation rules generally require a specified degree of common ownership in order for aggregation to apply. Accordingly, they appear not to apply to governmental employers, tax-exempt organizations and other entities that do not have owners. However, on occasion, the IRS has taken the position that such entities are subject to aggregation.[591] The IRS has requested comments on this issue and, pending the issuance of further guidance, a good faith compliance standard is in effect.[592] The argument for applying the aggregation rules to 403(b) plans, as opposed to qualified plans of governmental and tax-exempt employers, is even weaker, because the Code does not list section 403(b) among the sections to which the aggregation rules apply.

Contributions and Allocations

Under a SIMPLE IRA or SIMPLE 401(k) plan, the employer must make the matching or nonelective contribution required by the statute, for all employees who satisfy the eligibility requirements for the year in question. Additional contributions are not allowed.[593]

589. *Id.* § 414(b)-(c), (m).

590. *See id.* § 414(b)-(c), (m)(4).

591. *See, e.g.*, Priv. Ltr. Rul. 87-02-063 (Oct. 16, 1986); I.R.S. Notice 89-23, 1989-1 C.B. 654; I.R.S. Notice 90-73, 1990-2 C.B. 353.

592. *See* I.R.S. Notice 96-64, 1996-2 C.B. 229.

593. *See* I.R.C. §§ 408(p)(2), 401(k)(11)(B); *see also* I.R.C. §§ 408(p)(1)(B), 401(k)(11)(B)(i)(III).

Under a safe harbor 401(k) plan, the employer must again make the matching or nonelective contribution required by the statute, for all employees who satisfy the eligibility requirements for the year in question. Here, however, additional contributions (an enhanced matching contribution, or discretionary profit-sharing contributions) are allowed and, subject to satisfaction of the coverage and non-discrimination rules, may be allocated only to participants who satisfy additional requirements (for example, completion of 1000 hours of service during the year and/or employment on the last day of the year).[594]

Under a traditional 401(k) plan or a 403(b) plan, the contributions that are required or permitted are generally those described in the plan and, subject to satisfaction of the coverage, top-heavy and nondiscrimination rules, may be allocated only to participants who satisfy additional requirements (for example, completion of 1000 hours of service during the year and/or employment on the last day of the year).[595]

Under a 457 plan, the contributions that are required or permitted are generally those described in the plan and they may be allocated only to participants who satisfy certain requirements.[596]

Establishing the Plan

A traditional 401(k) plan must be established by the last day of the employer's taxable year in order for the employer to be allowed a deduction for that year.[597] A SIMPLE 401(k) plan or SIMPLE IRA must be maintained on a calendar year basis and, to be effective for a year, must be adopted by October 1 of that year.[598]

Safe harbor 401(k) provisions may be added to an existing plan at any time up to the first day of the eleventh month of the first plan year for which the plan is to be a safe harbor plan.[599] A calendar year profit-sharing plan can

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594. *See* Rev. Rul. 76-250, 1976-2 C.B. 124.
595. *See id.*
596. I.R.C. § 457(b).
597. *Id.* § 404(a).
598. I.R.S. Notice 98-4, 1998-1 C.B. 269.
599. See I.R.S. Notice 2000-3, 2000-1 C.B. 413.

be amended as late as October 1 to add a 401(k) option that uses a safe harbor for that year.[600]

With a 403(b) plan or 457 plan, employer deductions are not an issue, but the plan must be adopted before the first employer contributions or employee deferrals are made thereunder.

The Trustee

A SIMPLE IRA must use a corporate trustee or custodian.[601] Any type of 401(k) plan may have individuals (for example, officers of the employer) as trustees.

A 403(b) plan funded with annuity contracts is generally not trusteed. If the plan is funded through a custodial account, the custodian must be a bank or other person approved by the IRS.[602]

Assets of a 457 plan maintained by a private tax-exempt employer must remain subject to the claims of the employer's creditors.[603] Assets of a governmental 457 plan must be held in a trust or custodial account; there are no restrictions on the permissible trustees or custodians.[604]

Distributions

Under a 401(k) plan, distributions of amounts attributable to (1) elective deferrals, (2) amounts treated as elective deferrals and (3) the required employer contributions to a safe harbor plan are allowed only if a permissible distribution event has occurred.[605] Liberal distribution rules apply to other assets of a 401(k) plan,[606] but the employer is not required to allow distributions at all of the permissible times, for example, the employer need not allow in-service distributions.

Under a 403(b) plan, distribution restrictions apply to (1) amounts attributable to salary reduction contributions

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600. I.R.S. Notice 2000-3, 2000-1 C.B. 413.
601. *See* I.R.C. § 408(a)(2).
602. *Id.* § 401(f)(2), 403(b)(7)(A).
603. *See id.* § 457(b)(6).
604. *See id.* § 457(g).
605. *See supra* Part IV.C.
606. *See supra* Part IV.B.

and (2) all plan assets held in a custodial account (rather than an annuity contract).[607]

There are no distribution limitations for SIMPLE IRAs.[608]

Under a 457 plan, amounts may not be made available earlier than (1) the calendar year in which the participant attains age seventy and a half, (2) when the participant is separated from service with the employer, or (3) when the participant is faced with an unforeseeable emergency.[609]

Vesting

The following amounts are required to be fully vested at all times: (1) pre-tax elective deferrals under a 403(b) plan, a SIMPLE IRA, or any type of 401(k) plan; (2) amounts treated as elective deferrals under a 401(k) plan, namely qualified matching contributions (QMACs) and qualified nonelective contributions (QNECS); (3) the required employer contributions (matching or nonelective) to a SIMPLE IRA, SIMPLE 401(k) or safe harbor 401(k).

Other employer contributions (to a 401(k) plan, safe harbor 401(k) plan or 403(b) plan) may be subject to graduated vesting.[610]

There are no specific vesting requirements for 457 plans.[611]

Investments and Prohibited Transactions

As a general rule, a qualified plan (including any type of 401(k) plan) has a very broad range of permissible investments. The only limitations are as follows: (1) the plan and its fiduciaries must comply with the prudence,

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607. *See supra* Part IV.F.

608. However, the early distribution penalty tax is 25% (rather than 10%) on any distribution within the two-year period after the individual first began to participate. I.R.C. § 72(t)(6).

609. *Id.* § 457(d)(1)(A).

610. In practice, most 403(b) plans provide for full and immediate vesting, because to do otherwise further complicates the maximum exclusion allowance (MEA) calculation. *See* I.R.C. § 403(b)(6).

611. This assumes that the 457 plan is not subject to the ERISA vesting rules, which is generally the case. Similarly, there are no statutory vesting requirements for a 403(b) plan that is not subject to ERISA, but in practice virtually all such plans provide for full and immediate vesting. *See* I.R.C. §§ 401(a)(23), 409(o).

diversification and prohibited transaction rules, and with any limitations imposed by the plan documents;[612] (2) there are limitations on the acquisition and holding of employer securities and employer real property;[613] (3) the amount invested in life insurance contracts must be limited, so that the death benefit remains "incidental";[614] (4) acquisition of a collectible, by an individually directed account, is treated as a taxable distribution.[615]

The investments available to a 403(b) plan are much more limited: unless the employer is a church, the plan may invest only in annuity contracts issued by an insurance company or in regulated investment company stock (mutual funds).[616] However, if the plan is a defined contribution program, and the employer is a church, or a convention or association of churches, including a church-controlled organization, the employer may maintain a retirement income account,[617] which has all of the investment alternatives available to a qualified plan and, if it is exempt from ERISA (as most church plans are), will not be subject to the ERISA restrictions. It would, however, be subject to any restrictions imposed by state law.

A SIMPLE IRA is subject to the investment restrictions that apply to all IRAs (for example, no life insurance and no loans to the participant), and acquisition of a collectible is treated as a taxable distribution.[618] A SIMPLE IRA must also limit investment in qualifying employer securities and qualifying employer real property to 10% of its assets.

There are no explicit investment restrictions for 457 plans. If the plan is exempt from ERISA, then it will be subject to any limitations imposed by state law.

If a SIMPLE IRA engages in a prohibited transaction (PT), the entire value of the account is immediately taxable.[619] If a qualified plan, including any type of 401(k)

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612. I.R.C. § 4975; ERISA §§ 404(a)(1)(B)-(D), 406, 29 U.S.C. §§ 1104(a)(1)(B)-(D), 1106 (1994).

613. *See* ERISA § 407, 29 U.S.C. § 1107 (1994 & Supp. III 1997). The limitations relating to employer securities generally do not apply to any defined contribution plan that is an "eligible individual account plan." *See id.* § 407(b), 29 U.S.C. § 1107(b) (1994).

614. *See supra* notes 324-327 and accompanying text.

615. I.R.C. § 408(m)(1).

616. *See id.* § 403(b)(1), (7).

617. *Id.* § 403(b)(9).

618. *Id.* §408(m).

619. *Id.* § 408(e)(2).

plan, engages in a PT, there is a first tier excise tax equal to 15% of the "amount involved." If the PT is not corrected, there is a second tier excise tax equal to 100% of the amount involved.

Spousal Rights

A SIMPLE IRA or 457 plan is not subject to the qualified joint and survivor (QJSA) or qualified preretirement survivor annuity (QPSA) rules, regardless of who the beneficiary is. A 401(k) plan can escape these rules only if the participant's spouse receives 100% of the account balance on the participant's death, or consents to another beneficiary.

It is not always clear whether a 403(b) plan is subject to the rules. If the plan is exempt from ERISA, as a governmental plan or church plan,[620] or pursuant to the regulatory exemption for employee-funded plans, then the statutory annuity requirements do not apply. Also if, as is relatively rare, the 403(b) plan document specifies that the plan is a profit-sharing plan rather than a pension plan, the plan can escape the rules if the participant's spouse receives 100% of the account balance on the participant's death, or consents to another beneficiary. However, even if the plan is not subject to the annuity rules, many 403(b) plan documents, particularly those drafted by insurance companies, provide for annuities anyway.

Income Taxation of Distributions

In general, distributions from qualified plans and IRAs are subject to taxation as ordinary income, except to the extent that they represent a return of basis.

In the case of a participant born before 1936, certain lump sum distributions qualify for favorable averaging or capital gains treatment. This does not apply to 403(b) plans, 457 plans or SIMPLE IRAs.

Most distributions before age fifty-nine are subject to a 10% additional income tax.[621] This tax applies to 401(k) plans, 403(b) plans and SIMPLE IRAs, but not to section

620. ERISA § 4(b)(1)–(2), 29 U.S.C. § 1003(b)(1)–(2) (1994 & Supp. II 1996).

621. I.R.C. § 72(t)(A)(i). For a discussion of the tax and the numerous exceptions, see *supra* Part VII.B.

457 plans. For the first two years of a SIMPLE IRA, the rate of tax is 25%.

An "eligible rollover distribution" from a qualified plan may be rolled over to another qualified plan or to an IRA. An eligible rollover distribution from a 403(b) plan may be rolled over to another 403(b) plan or to an IRA. An eligible rollover distribution from an IRA may be rolled over to another IRA. Unless the distribution is directly rolled over, an eligible rollover distribution from a qualified plan or 403(b) plan is subject to mandatory 20% income tax withholding: this does not apply to distributions from an IRA.[622] Distributions from a 457 plan are not eligible for rollover, and thus are not subject to mandatory withholding, but a direct transfer may be made from one 457 plan to another.[623]

The constructive receipt rule does not apply to qualified plans, 403(b) plans or IRAs,[624] but does apply to 457 plans.[625]

Elective Deferrals

In general, elective deferrals under a 401(k) plan must satisfy the actual deferral percentage (ADP) test. However, safe harbor 401(k) plans and SIMPLE 401(k) plans are deemed to satisfy the test.[626] Elective deferrals under a 403(b) plan, SIMPLE IRA or 457 plan are not subject to discrimination testing. The maximum elective deferral under each type of plan is as follows (all of the dollar limits shown are those in effect for 2001, and all are subject to cost of living increases).[627]

For 401(k) plans, the dollar limit is the least of (1) $10,500, (2) the maximum allowed by the ADP test, or (3) 25% of compensation (including the deferral).

For SIMPLE 401(k) plans, the dollar limit is the lesser of (1) $6500 or (2) 25% of compensation (including the deferral).

622. For a discussion of rollovers, see *supra* Part VII.C.
623. *See* I.R.C. § 457(e)(10).
624. *See id.* § 402(a), 403(b)(1), 408(d)(1).
625. *See id.* § 457(a).
626. *See id.* § 401(k)(11)(A), 401(k)(12)(A).
627. *See id.* §§ 402(g), 408(p)(2)(A)(ii), 457(b)(2); *see also* I.R.S. Notice 2000-66, 200-2 C.B. 600.

For safe harbor 401(k) plans, the dollar limit is the lesser of (1) $10,500 or (2) 25% of compensation (including the deferral).

For 403(b) plans, the dollar limit is the least of (1) $10,500,[628] (2) the maximum exclusion allowance for that year, or (3) 25% of compensation (including the deferral).[629]

For SIMPLE IRAs, the dollar limit is the lesser of (1) $6500, or (2) 100% of compensation (including the deferral).

For 457 plans, the dollar limit is the lesser of (1) $8500 or (2) 25% of compensation (including the deferral).[630]

Administrative Issues

A SIMPLE IRA is very easy and inexpensive to establish; most vendors simply use an IRS form, Form 5305-SIMPLE or Form 5305A-SIMPLE. Also, if certain requirements are satisfied, no annual reports (Form 5500) need be filed and no summary plan description (SPD) prepared.[631] 401(k) and 403(b) plans can also be adopted inexpensively, by using one of the many available prototypes: however, an annual report (Form 5500) must be filed and a summary plan description (SPD) prepared, if the plan is subject to ERISA.

In the absence of a complaint from a participant, a SIMPLE IRA is unlikely to be audited by IRS or DOL. Both agencies have ongoing audit programs for qualified plans and 403(b) plans.

Creditor Protection

In *Patterson v. Shumate*,[632] the Supreme Court held that benefits under an "ERISA-qualified" plan were protected from claims of creditors in the employee's bankruptcy. It is still not clear which plans are covered by this decision. However, even if the plan is not "ERISA qualified," an anti-

628. Certain participants may defer as much as $13,500. *See* I.R.C. § 402(g)(8).

629. Certain participants may make one of three special elections, which allow them to defer a higher percentage of compensation. *Id.* § 415(c)(4)(B).

630. The deferral may be as much as $15,000 for any one or more of the participant's last three taxable years before he or she attains normal retirement age under the plan. *Id.* § 457(b)(3).

631. *See* ERISA § 101(h), 29 U.S.C. § 1021 (1994 & Supp. II 1996); I.R.S. Notice 98-4, 1998-1 C.B. 269.

632. 504 U.S. 753, 758-60 (1992).

alienation provision in the plan itself may be sufficient to protect the assets from creditors' claims. The extent of the protection for assets held in an IRA, including a SIMPLE IRA, is a matter of state law.[633]

An employee's benefits under a qualified plan, 403(b) plan, governmental 457 plan or SIMPLE IRA are fully protected against claims of the employer's creditors, as soon as the funds have been contributed by the employer. However, assets of a private employer's 457 plans are required to be subject to the claims of the employer's general creditors.[634]

633. The Investment Company Institute has prepared a helpful chart showing the extent of the protection enjoyed by each type of IRA under the laws of each state. *See* Investment Company Institute, *supra* note 574; *see also* Altieri & Naegele, *supra* note 574.

634. *See* I.R.C. § 457(b)(6).

Appendix D

SPECIAL RULES FOR PLANS THAT INVEST IN EMPLOYER SECURITIES

	ESOP	**Stock Bonus**	**Profit-Sharing**	**Pension**[635]
Can plan hold employer securities that are not "qualifying employer securities"?[636]	No	No	No	No[637]
Can employer securities exceed 10% of total value of plan assets?[638]	Yes	Yes	Yes	No[639]
Is the plan subject to the diversification rule with respect to employer securities?	No	No	No	Yes[640]
Must employer securities held by the plan meet the I.R.C. § 409(l) definition of that term?	Yes	No	No	No
Can the plan use the I.R.C. § 404(a)(9) higher deduction limit?	Yes	No	No	No
Can person who sells employer stock to plan elect not to recognize gain under § 1042?	Yes	No	No	No

635. For this purpose, the term "pension plan" does not include a money purchase plan that is part of an ESOP.

636. *See supra* Part VIII.A.

637. There is an exception for money purchase plan that invested primarily in employer securities on September 2, 1974. Also, an ESOP, profit-sharing, or stock bonus plan may *not* do so if benefits are taken into account in determining the benefits under a defined benefit plan. *See supra* Part VIII.B

638. *See supra* Part VIII.A.

639. *See supra* Part VIII.A.

640. *See supra* Part VIII.A.

	ESOP	Stock Bonus	Profit-Sharing	Pension[641]
Is the plan subject to the diversification rule?[642]	Yes	No	No	No
If the plan's stock is not readily tradable, must all valuations be by an independent appraiser?[643]	Yes	No	No	No
Pass-through voting rights?[644]	Yes	No	No	No[645]
Right to receive distribution of employer securities?[646]	Yes	Yes	No	No
Put option?[647]	Yes	Yes	No	No
Accelerated distribution rule?[648]	Yes	Yes	No	No

641. For this purpose, the term "pension plan" does not include a money purchase plan that is part of an ESOP.

642. I.R.C. § 401(a)(28)(B); *see also supra* Part VIII.D.2.

643. I.R.C. § 401(a)(28)(C); *see also supra* Part VIII.D.2.

644. I.R.C. § 409(e); *see also supra* Part VIII.D.3.

645. The rules also apply to a stock bonus plan or money purchase plan, if (1) more than 10% of its assets are employer securities, and (2) the plan is established by an employer whose stock is not readily tradable on an established market. *See* I.R.C. § 401(a)(22).

646. I.R.C. § 409(h); *see also supra* Part VIII.D.3.

647. I.R.C. § 409(h)(4); *see also supra* Part VIII.D.3.

648. *See* I.R.C. §§ 401(a)(23), 409(o); *see also supra* Part VIII.D.3.